

Corporate Political Activity and Non-Shareholder Agency Costs

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The Supreme Court's controversial decision in Citizens United, much like its previous decision in Bellotti, was based in part on the notion that dissenting shareholders are sufficiently protected by state corporate law and the priority it accords to shareholder interests. There has been much debate in recent years over whether the Court's reasoning was sound. Absent from this conversation is any discussion of the interests of non-shareholders, such as employees and creditors, even as their importance to the corporation has become increasingly recognized in recent years.

The courts have never considered the problem of dissenting non-shareholders in assessing regulatory restrictions on corporate political activity. This Article argues that they should. It is the first to explore the potential agency costs that corporate political activity creates for non-shareholders, and in so doing, it lays out two main arguments. First, these agency costs may be significant, as I illustrate through several case studies. Second, neither corporate law nor private ordering provides solutions to this agency problem. Indeed, because the theoretical arguments for shareholder primacy in corporate law are largely inapplicable for corporate political activity, corporate law may actually serve to exacerbate the agency problems that such activity creates for non-shareholders. Private ordering, which could take the form of contractual covenants restricting corporate political activity, also seems unlikely to solve this problem, due to the large economic frictions facing such covenants.

These findings have potentially significant ramifications for the Court's corporate political speech jurisprudence, particularly as laid out in Bellotti and Citizens United. One logical conclusion is that these decisions, regardless of their constitutional merit, make for very bad public policy, insofar as they preempt much-needed regulatory solutions for reducing non-shareholder agency costs, and thus may have the effect of inhibiting efficient corporate

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ordering and capital formation. Another outgrowth of this analysis is that non-shareholder agency costs may provide an important rationale for government regulation of corporate political activity.

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Introduction

This Article explores the potential agency costs created by corporate political activity (CPA) for non-equity stakeholders in the public corporation. There has been a significant and growing body of work focusing on shareholder agency costs arising from CPA,¹ particularly since the Supreme Court's controversial decision in

1. Consistent with much of the literature on agency problems arising from corporate attempts to influence political or regulatory actors, I use the term "corporate political activity" or "CPA" in a very broad sense, "to encompass any corporate activity intended to influence the political process and/or political decision making, i.e., elections for political or judicial office, law-making (both legislative and regulatory), or simply adding to the political discourse on issues of public concern." Jay Kesten, *Democratizing Corporate Political Activity*, 10 VA. L. & BUS. REV. 161, 163 n.1 (2016). See also Sean Lux et al., *Mixing Business With Politics: A Meta-Analysis of the Antecedents and Outcomes of Corporate Political Activity*, 37 J. MGMT. 223, 223-24 (2011) (citing Amy J. Hillman et al., *Corporate Political Activity: A Review and Research Agenda*, 30 J. MGMT. 837 (2004) (defining CPA in a similar way)). This includes direct contributions to political candidates (which are outlawed under the Tillman Act of 1907), independent political expenditures (which were the subject of the campaign finance laws at issue in *Citizens United*), contributions to political parties, contributions to PACs, contributions to Super PACs, contributions to trade groups and advocacy groups, advertising meant to move public policy, the hiring of former political officials, as well as expenditures related to lobbying. See Kesten, *supra*; see also ROBERT J. SHAPIRO & DOUGLAS DOWSON, MANHATTAN INST. CTR. FOR PUB. POLICY, CORPORATE POLITICAL SPENDING: WHY THE NEW CRITICS ARE WRONG (2012); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 93-97 (2010) (using a broad, if undefined, view of "corporate political speech," which includes all "lobbying and political expenditures," donations to trade groups and non-profit advocacy organizations such as the Chamber of Commerce, and funds spent on sponsoring and promoting corporate political action committees, to analyze the shareholder agency costs of CPA); John C. Coates, IV, *Corporate Politics, Governance, and Value Before and After Citizens United*, 9 J. EMPIRICAL L. STUD. 657, 660-665 (2012) (using a broad definition of "corporate political activity" to analyze shareholder agency costs); Timothy Werner & John J. Coleman, *Citizens United, Independent Expenditures, and Agency Costs: Reexamining the Political Economy of State Antitakeover Statutes*, 31 J. L. ECON. & ORG. 127, 129-130 (2014) (using a similarly broad definition of "corporate political activity" in looking at the conflicts between shareholders and managers). While much of the CPA agency cost literature has focused on corporate political expenditures, either through PACs or independent expenditures, corporate lobbying may actually be far more important in influencing the passage, implementation, and interpretation of laws and regulations. See Adam Bonica, *Avenues of Influence: On the Political Expenditures of Corporations and Their Directors and Executives* 2, 7-9 (July 10, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2313232 (noting that corporate lobbying expenditures have historically eclipsed PAC contributions by a ratio of more than ten to one, and that corporate lobbying accounted for at least 68% of federal lobbying expenditures in 2010). Lobbying is typically understood to be complementary to corporate political expenditures, and a firm that engages in one type of CPA typically engages in several types of CPA. *Id.* The campaign finance

Citizens United, which rejected governmental restrictions on corporate independent expenditures based on First Amendment grounds.² The majority opinion in *Citizens United*, echoing the Court's previous reasoning in *First National Bank of Boston v. Bellotti*,³ supported the general proposition that the protection of shareholder interests against potential agency conflicts could be an appropriate basis for regulating corporate political speech, but held that existing "procedures of corporate democracy" found in state corporate law were already sufficient to address any such concerns.⁴ A flood of theoretical and empirical research, both before and particularly after *Citizens United*, has sought to provide insight into whether corporate law adequately addresses the problem of shareholder agency costs that might arise from CPA.

The agency cost framework, which looks at the potential divergence of interests between managers and outside owners of the corporation has long been a central focus of corporate law, and thus has been a primary lens through which corporate law scholars have studied CPA. But it is important to recognize that CPA has always been considered from the perspective of shareholders. This is true not only of the Supreme Court, which has had a long history of equating corporations with their shareholders, but also of corporate law scholarship. But while the question of shareholder agency costs arising from CPA has been (and continues to be) well covered, there has been no such analysis of the potential agency costs faced by non-shareholders, despite the existence of a fairly deep literature that explores the agency costs faced by non-shareholders generally in corporate governance. The failure to consider the agency conflicts created by CPA for non-shareholders is an enormous oversight, given the outsized role that non-equity inputs play in the success of a typical corporation. For example, debt investors provide a huge source of financing for corporations, particularly large publicly traded corporations. Non-

literature has tended to focus on specific subsets of CPA, including corporate campaign contributions and corporate political expenditures. This is in part because the Court's jurisprudence in this area has largely focused on the anti-distortion and anti-corruption rationales for regulating CPA, and these rationales justify a far narrower scope of regulation, limited to those forms of corporate political speech that may be seen as having undue influence or a corruptive effect. See Alan J. Meese, *Limitations on Corporate Speech: Protection for Shareholders or Abridgement of Expression?*, 2 WM. & MARY BILL RTS. J. 305, 307 (1993). But focusing on the agency problems faced by shareholders and other investors, as the shareholder protection rationale does, justifies a far broader sweep of regulatory restrictions—as Meese has stated, such a rationale "will support the restriction of *any* corporate speech," whether or not such activity may have an unduly distortive effect or promote corruption. *Id.* Thus, a broad definition of CPA is appropriate for this Article for two reasons: first, because any type of CPA raises the potential problem of agency conflicts within the firm; and second, because, from the perspective of corporate stakeholders, findings made as to one type of CPA may illustrate more broadly the problems with other types of CPA as well.

2. *Citizens United v. Federal Election Comm'n*, 558 U.S. 310 (2010).

3. 435 U.S. 765, 794-795 (1978) (stating that "the procedures of corporate democracy," including shareholders' "power to elect the board of directors or [change] the corporation's charter," along with shareholders' ability to file derivative suits, were sufficient to protect shareholder interests).

4. 558 U.S. at 361-62. Conversely, the dissent argued that these "procedures of corporate democracy" are actually "so limited as to be almost nonexistent," and concluded that shareholder agency costs are quite large and thus justify regulation. *Id.* at 476-77 (Stevens, J., concurring in part and dissenting in part) (quoting Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 320 (1999)).

financial corporations had \$7.718 trillion in total debt outstanding in 2015.⁵ This accounted for 34.4% of the capital structure for corporations in the United States.⁶

Employees are also critical to the success of the firm, and while it is difficult to measure the quantitative value of their importance to the firm, or the value of their human capital investments, these are clearly substantial. Overall, the agency conflicts faced by non-shareholders may be larger and more intractable than those of shareholders, given that non-shareholders are further removed from the mechanisms of corporate control. Moreover, as shareholder advocates have managed to more closely align the interests of corporate decision makers and the interests of shareholders in recent decades, this has created a greater potential for conflict between the corporation's managers and its non-shareholder constituents.

Indeed, even shareholder primacy today is rooted in a theoretical approach that recognizes the importance of non-shareholder constituencies. One of the most widely accepted theories in corporate law today, the "nexus of contracts" approach, explicitly recognizes the importance of non-shareholder constituencies in the corporation. This contractarian paradigm, which builds on Ronald Coase's insight that the firm exists to minimize high transaction costs, envisions the corporation as a "nexus" at the center of a web of contractual and quasi-contractual relationships with its various stakeholders, such as managers, shareholders, creditors, customers, and non-managerial employees. While the contractarian theory also prioritizes the interests of shareholders over those of other stakeholders, it does so based on the claim that shareholder primacy is what the corporate stakeholders themselves would have agreed to in a hypothetical bargain without transaction costs. As such, shareholder primacy is asserted to reflect the default rules of corporate governance, insofar as it most efficiently facilitates private ordering.

Conventional legal and economic analyses have long tended to dismiss the agency conflicts faced by non-shareholders by asserting that these agency conflicts are best addressed through private ordering, most notably the negotiation of contracts to protect the fixed interests of these stakeholders.⁷ Shareholders, under this account, are more poorly situated to protect their interests through contract, and their incentives are best aligned to maximize value for all of the corporation's constituents, due to their status as residual claimants. But, as I argue in this Article, even if one accepts these arguments for shareholder primacy in corporate governance generally, a deeper inquiry demonstrates that these same arguments fail when it comes to corporate governance of political activities.

And if the case for shareholder primacy in CPA fails, then it becomes clear that the resulting non-shareholder agency costs are potentially quite significant and perhaps intractable in the absence of external regulation of CPA, regulation of

5. See BD. OF GOVERNORS OF THE FED. RES. SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS (2015) 79 tbl.L.103 [hereinafter 2015 FLOW OF FUNDS REPORT].

6. *Id.* (showing total corporate debt of \$7.1777 trillion, which is roughly 34.4% of the listed total market value of corporate equities of \$22.4439 trillion).

7. As Frederick Tung has stated, "Traditionally, the central challenge [in corporate law] has been to design governance arrangements optimally to close the gap between ownership and control: to channel managers' discretion to benefit one specific class of investor—common shareholders." Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV 115, 117-18 (2009).

precisely the kind that the Supreme Court struck down in *First National Bank of Boston v. Bellotti* and *Citizens United*.

This Article proceeds in five parts. Part I describes the historical emphasis on shareholder agency costs in CPA. It points out that a consistent thread throughout corporate political speech jurisprudence and the scholarship analyzing this has been the notion that shareholder agency problems are a valid basis for regulating CPA. Part II looks more broadly at agency costs in the context of corporate governance, reviewing some of the literature on non-shareholder agency costs and describing the contractarian argument for elevating the agency concerns of shareholders over those of non-shareholders. Part III makes the argument that CPA does create agency costs, and that these can be potentially very large. I lay out several examples of CPA that served the interests of shareholders and harmed the interests of non-shareholders. Part IV argues that neither corporate law nor private ordering ameliorates these agency costs. Even if we accept the argument that corporate law's prioritization of shareholder interests is appropriate and efficient for corporate governance generally, a closer analysis demonstrates that shareholder primacy is problematic when it comes to CPA. I also look at the prospect of contractual covenants as a private ordering mechanism for reining in non-shareholder agency costs, but conclude that the economic and constitutional barriers to such covenants make them impracticable. In Part V, I explore some of the implications of my arguments, before concluding.

I. Corporate Political Activity and Shareholder Agency Costs

The Supreme Court's controversial decision in *Citizens United* sparked a wave of corporate law scholarship criticizing the Court's conception of the corporation and its terse dismissal of the shareholder protection rationale for governmental restrictions on corporate political expenditures. As I describe below, virtually all of these corporate law critiques of *Citizens United* have focused on the problem of the dissenting shareholder who does not want her invested capital to be spent on political causes with which she disagrees. This problem of the dissenting shareholder has been generally described as a principal-agent conflict between the outside shareholder and the manager making decisions on behalf of the corporation.⁸

As this Part explains, concerns about shareholder agency issues have long been an important justification for legislative restrictions on CPA, and a central focus of both the Supreme Court's corporate rights jurisprudence addressing such restrictions and the corporate law scholarship related to this jurisprudence. Even the Court's decisions in *Bellotti* and *Citizens United*, which struck down restrictions on corporate political expenditures, acknowledge the importance of shareholder agency problems, while finding that these are ameliorated by existing corporate law and its "procedures of corporate democracy."

8. I discuss the agency framework in greater detail *infra* in Part II.

A. “Other People’s Money” and Shareholder Interests

As a number of corporate law scholars have noted, while the Court has significantly expanded corporate rights in recent decades (and particularly since the confirmation of Chief Justice Roberts), it has not grounded this expansion of corporate rights in any coherent theory of the corporation or corporate personhood.⁹ But while the Court’s theoretical articulation of corporate rights may be underdeveloped, there does appear to be one common thread throughout the Court’s jurisprudence in this area—the principle that corporate rights are based in “concerns about the property and contract interests of shareholders.”¹⁰ Indeed, the protection of shareholder interests has historically always been a primary justification for regulating CPA, as I describe in this section.

Efforts to restrict CPA did not begin until the early 20th century, primarily because such activity was prohibited until at least the late 19th century under the doctrine of *ultra vires*. This doctrine strictly limited the activities of corporations, including lobbying, to those authorized by their corporate charters.¹¹ The frequent assertion of *quo warranto* proceedings¹² by state attorneys general challenging corporate political activity of any kind reinforced the idea that the expenditure of any money for political activity was impermissible for corporations.¹³ Even after

9. See, e.g., Stefan J. Padfield, *The Silent Role of Corporate Theory in the Supreme Court’s Campaign Finance Cases*, 15 J. CONST. L. 831, 857-860 (2013) (noting that the modern Court has not yet adopted a theory of the corporation or its accompanying rights); Elizabeth Pollman, *Reconceiving Corporate Personhood*, 2011 UTAH L. REV. 1629, 1657 (2011) (“While the Court has significantly expanded corporate rights, it has not grounded these expansions in a coherent concept of corporate personhood.”); Stephen Bainbridge, *Schumpeter on Corporate Personhood*, PROFESSORBAINBRIDGE.COM (Mar. 26, 2011, 6:43 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2011/03/schumpeter-on-corporate-personhood.html> (“While I agreed with the holding [in Fed. Comm’n Comm’n v. AT&T, Inc., 562 U.S. ___, 131 S. Ct. 1177 (2011)], I was disturbed that the Chief Justice’s majority opinion for the Supreme Court so obviously lacked a coherent theory of the nature of the corporation and, as such, also lacked a coherent theory of what legal rights the corporation possesses.”). But see Paul S. Miller, *Shareholder Rights: Citizens United and Delaware Corporate Governance Law*, 28 J.L. POL. 51, 75-79 (2012) (arguing that “*Citizens United* clearly states its vision of shareholder democracy” insofar as all of the Justices emphasize the rights of shareholders, and the debate between the majority and dissent revolve solely around the effectiveness of “the procedures of corporate democracy” in allowing shareholders to control the corporation’s political speech). Consistent with Miller’s argument, some commentators have noted that Justice Kennedy’s majority opinion seems to expressly invite regulation that might improve the “procedures of corporate democracy,” so as to ameliorate the problem of dissenting shareholders. See, e.g., Jamie B. Raskin, *A Shareholder Solution to ‘Citizens United,’* WASH. POST, Oct. 3, 2014.

10. Elizabeth Pollman, *Reconceiving Corporate Personhood*, *supra* note 9 at 1630.

11. See generally Leo E. Strine, Jr. & Nicholas Walter, *Originalist or Original: The Difficulties of Reconciling Citizens United With Corporate Law History* 74, 80 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 812, 2015). See also McConnell v. Combination Mining & Milling Co., 79 P. 248, 251 (Mont. 1905) (holding that directors could not charge corporations for lobbying expenses).

12. *Quo warranto* proceedings are writ actions requiring those wielding some form of sovereign power to demonstrate the source of their authority. Today, they are most commonly used to require public office holders to show that they are legally permitted to hold their position. See CAL. ATT’Y GEN. OFFICE, *QUO WARRANTO: RESOLUTION OF DISPUTES—RIGHT TO PUBLIC OFFICE* 7-8 (1990).

13. Edward G. Reitler, *Austin v. Michigan Chamber of Commerce: Reexamining Corporate Political Rights Under the First Amendment*, 11 U. BRIDGEPORT L. REV. 449, 454 (1991)

states began chartering general business corporations in the late 18th century, shareholders continued successfully to assert *ultra vires* actions against corporate political expenditures.¹⁴ It was not until the late 19th century that corporations began to make significant expenditures related to political activity,¹⁵ and even then, these activities were deemed unlawful under the *ultra vires* doctrine until well into the 20th century.¹⁶

Perhaps because CPA was seen as impermissible under *ultra vires*, and certainly because of the fear of public backlash, the first corporate engagements with politics in the late 19th and early 20th centuries were done in secrecy.¹⁷ Because there were no campaign finance laws in place at this time, the public was largely unaware of this activity.¹⁸ Corporations were heavily involved in the 1888, 1892, 1896, 1900, and 1904 elections with little public suspicion of, and thus no public outcry over, the extent of their political activities.¹⁹ This all changed in 1905, as a series of scandals at the major New York life insurance companies involving corporate political spending drove the New York State legislature to create the eponymous “Armstrong Committee,” named after its chair, state Senator William Armstrong. The Armstrong Committee held hearings through the second half of 1905 and uncovered evidence of massive donations secretly made by the largest life insurance companies to the Republican National Committee and the campaign fund of Theodore Roosevelt.²⁰ These findings were front page news across the country,²¹ and sparked a popular outrage that is widely credited with spurring the passage of the Tillman Act of 1907, which bans corporate contributions to political candidates,²² as well as a wave of state legislation banning corporate political expenditures and contributions beyond the restrictions already created by the

(citing Charles W. McCurdy, *The Knight Sugar Decision of 1895 and the Modernization of American Corporation Law 1869-1903*, 53 BUS. HIST. REV. 304, 305 (1979); Att’y Gen. v. Great E. Ry. Co., 11 Ch. D. 449, 503 (1879) Lord Bramwell (upholding the power of the attorney general to proceed against a corporation for *ultra vires* acts)).

14. Strine & Walter, *supra* note 11, at 74-75 & nn. 321-28.

15. See ROBERT E. MUTCH, CAMPAIGNS, CONGRESS, AND COURTS 165 (1988) (describing how, beginning in 1896, Mark Hanna, the Chairman of the Republican National Party, began to “systematize” political fundraising from corporations).

16. *People ex rel. Perkins v. Moss*, 80 N.E. 383, 387 (N.Y. 1907) (“The company had not the right, under the law of its existence, to agree to make contributions for political campaigns, any more than to agree to do other things foreign to its charter”); *McConnell v. Combination Mining & Milling Co.*, 76 P. 194, 199 (Mont. 1904) (“[Political expenditures] were clearly outside the purposes for which the corporation was created”). As Mutch describes, the view of CPA as *ultra vires* was considered a settled question until at least the 1950s. MUTCH, *supra* note 15, at 178-179.

17. MUTCH, *supra* note 15, at 1-2 (explaining that CPA was “generally considered to be illegitimate and so was carefully concealed”).

18. *Id.*

19. See Adam Winkler, “Other People’s Money”: Corporations, Agency Costs, and Campaign Finance Law, 92 GEO. L.J. 871, 881-87 (2004); MUTCH, *supra* note 15, at 1-16, 165-66.

20. MUTCH, *supra* note 15, at 2-3.

21. Winkler, *supra* note 19, at 888-90.

22. Tillman Act of 1907, ch. 420, Pub. L. No. 59-36, 35 Stat. 864 (codified as amended at 2 U.S.C. § 441b); see also MUTCH, *supra* note 15 (describing how popular opinion pushed Congress to enact the Tillman Act); Winkler, *supra* note 19, at 883-86.

Tillman Act.²³ Between 1905 and 1917, twenty-eight states enacted such laws (in addition to the five states that already had such laws in place before 1905).²⁴

Importantly, as Adam Winkler has documented, this public outrage was primarily directed at concerns about the misuse of “other people’s money” by corporate executives.²⁵ Public rhetoric and press accounts described corporate campaign contributions, funded out of the general treasuries of these corporations, as essentially “embezzlement” or “theft” of shareholder money to advance the political interests of corporate insiders, such as by influencing legislators to pass laws that shielded them from oversight and accountability.²⁶ As Winkler notes, this view of corporate political activity as a potential problem of managers misusing “other people’s money” is essentially a formulation of the principal-agent problem.²⁷

In short, up until the late 19th century, CPA was barred under the doctrine of *ultra vires*. When corporations began to engage in CPA notwithstanding these legal limitations, Congress and state legislatures responded with external laws—not grounded in corporate law—restricting CPA, and these regulatory restrictions were based on a shareholder protection rationale that viewed CPA as a potential problem of agency conflict between outside shareholders and inside managers. Shareholder protection remained a central animating consideration in the Tillman Act and other regulatory restrictions on corporate political activity up until the 1970s.²⁸

23. Lobbying bans were not part of this wave of legislation, in part because it has long been understood that lobbying is “squarely” protected by both the Free Speech and Petition Clauses of the First Amendment. See Richard L. Hasen, *Lobbying, Rent Seeking, and the Constitution*, 64 STAN. L. REV. 191, 196 (2012). Thus, in the post-*ultra vires* era, state and federal laws generally have not sought to ban lobbying. One notable exception to this rule is the case of Georgia, which enacted a statute in 1877 criminalizing lobbying of the Georgia general assembly, which was subsequently punishable by a prison term of one to five years. This statute remained on the books until 1992. See William N. Eskridge, Jr., *Federal Lobbying Regulation: History Through 1954*, in THE LOBBYING MANUAL 6-7 & 15 n.7 (William V. Luneberg et al. eds., 4th ed. 2009). To the extent that there has been state and federal regulation of lobbying, this has primarily come in the form of disclosure requirements or restrictions on the ancillary activities of lobbyists. Such restrictions may, for example, limit lobbyists’ campaign contributions to a particular candidate; prevent them from serving in a fundraising role in a campaign; ban “contingent-fee” lobbying, where a lobbyist receives a certain percentage of whatever contracts she might help to procure for a client; or impose “revolving-door” terms, where former government officials are barred from becoming lobbyists for some period of time after leaving office. See Hasen, *supra*, at 200-07.

24. See Ray La Raja & Brian F. Schaffner, *The Effects of Campaign Finance Spending Bans on Electoral Outcomes: Evidence From the States*, 33 ELECTORAL STUD. 102, 112 app. 1 (2014).

25. See Winkler, *supra* note 19, at 893-98, 912-26.

26. *Id.* at 893-985. But see *Cort v. Ash*, 422 U.S. 66, 81-82 (1975) (stating that the legislative history of the Tillman Act “demonstrates that the protection of ordinary stockholders was at best a secondary concern” and that the Act was “primarily concerned with corporations as a source of aggregated wealth and therefore of possible corrupting influence, and not directly with the internal relations between the corporations and their stockholders”). But the *Cort* court still acknowledged that agency concerns about the relationship between shareholders and the corporation were an appropriate basis for regulation. *Id.* at 84 (stating that express federal law or state law could “govern the internal affairs of the corporation”).

27. See Winkler, *supra* note 19, at 906-12.

28. As Winkler recounts, agency costs were an important consideration in a series of cases the Court decided between 1948 and 1972, collectively called the *Segregated Fund Cases*. These cases allowed unions to set up Political Action Committees (PACs), which I describe in greater detail in Part III.B, based on the idea that the funds’ money was contributed voluntarily and not simply taken out

B. Shareholder Protection in the Post-Bellotti Era

The regulatory framework for corporate political activities was radically upended by the Court's decision in *First National Bank of Boston v. Bellotti*, in which Justice Powell, writing for a 5-4 majority, invalidated a state ban on corporate political expenditures on ballot initiatives that were unrelated to the firm's core business interests, on the grounds that such spending was protected by the First and Fourteenth Amendments' free speech protections.²⁹ Importantly, while the *Bellotti* majority rejected the argument that shareholder protection justified this ban, it did expressly recognize that the protection of shareholders against the misuse of their invested money constitutes "an interest that is both legitimate and traditionally within the province of state law."³⁰

The *Bellotti* majority's invalidation of the statute in question relied critically on its assertion that shareholders already had adequate corporate governance measures in place to protect their interests, in the form of "procedures of corporate democracy" established by state corporate law. These procedures included shareholders' "power to elect the board of directors or to insist upon protective provisions in the corporation's charter," as well as shareholders' "access to the judicial remedy of a derivative suit to challenge corporate disbursements alleged to have been made for improper corporate purposes or merely to further the personal interests of management."³¹ In other words, while the *Bellotti* decision clearly acknowledged the legitimacy and importance of shareholder agency problems as a basis for restricting corporate political expenditures, it found that existing corporate law measures were sufficient to address these shareholder agency concerns.

The *Bellotti* decision faced heavy criticism for failing to acknowledge the complexities of the relationship between the corporation and the shareholder. Victor Brudney, voicing a common view of the time, argued that the Court's corporate political speech jurisprudence following *Bellotti* "d[id] not address the problem of defining the appropriate relationship between corporate political power . . . and stockholders' individual political preferences."³² As Brudney noted, there are significant potential agency conflicts between shareholders and managers when it comes to corporate political activity, and these conflicts are not necessarily resolved through existing corporate law mechanisms.³³ To illustrate this agency problem, he offered the example of a racist and sexist CEO who utilizes the corporation's general treasury to give generously to a candidate who wants to pass a constitutional amendment allowing race- and sex-based employment

of a union's general treasury. See Winkler, *supra* note 19, at 930-33 (citing *United States v. CIO*, 335 U.S. 106 (1948); *United States v. UAW-CIO*, 352 U.S. 567 (1957); *Pipefitters Local Union No. 562 v. United States*, 407 U.S. 385 (1972)). While these cases were nominally limited to unions, it was clear that the logic also applied to corporations. Corporations responded to the *Segregated Funds Cases* by setting up their own PACs and encouraging their employees and shareholders to contribute, to avoid violating the Tillman Act and other state and federal prohibitions on direct CPA. *Id.* at 933-35.

29. 435 U.S. 765 (1978).

30. *Id.* at 791.

31. *Id.* at 794-795.

32. Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L.J. 235, 239 (1981).

33. *Id.* at 242-45.

discrimination, even though discriminating in this way will raise the firm's cost of labor and thus be detrimental to the interests of its shareholders.³⁴ As Brudney's example shows, understanding and resolving the agency conflicts between shareholders and managers is essential to answering the question of who is engaging in corporate speech.

In the aftermath of *Bellotti*, the Court appeared to retreat from the strong view of corporate political speech rights it had articulated in that opinion. A series of subsequent decisions, including the Court's 1982 decision in *FEC v. National Right to Work Committee (NRWC)*,³⁵ its 1986 decision in *FEC v. Massachusetts Citizens for Life (MCFL)*,³⁶ its 1990 decision in *Austin v. Michigan Chamber of Commerce*,³⁷ and its 2003 decision in *FEC v. Beaumont*,³⁸ all seemed to reject the reasoning in *Bellotti*, to the point where many election law scholars believed that that decision was no longer good law.³⁹ From a corporate governance perspective, these cases seemed to depart significantly from *Bellotti*'s assertion that "procedures of corporate democracy" were sufficient to address potential shareholder agency problems.

In *NRWC*, the Court upheld restrictions on corporate political contributions based in part on the rationale that such restrictions were necessary to "protect the individuals who have paid money into a corporation . . . from having that money used to support political candidates to whom they may be opposed."⁴⁰ In *MCFL*, the Court struck down restrictions on political expenditures as applied to a nonprofit, nonstock corporation incorporated for the singular purpose of "foster[ing] respect for human life."⁴¹ In reaching this decision, the Court found it "essential" that the corporation in question "ha[d] no shareholders or other persons affiliated so as to have a claim on its assets or earnings" who might face "an

34. *Id.* at 243.

35. 459 U.S. 197 (1982).

36. 479 U.S. 238 (1986).

37. 494 U.S. 652 (1990).

38. 539 U.S. 146 (2003).

39. See, e.g., Jill Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587, 613 (1991) ("[e]ven superficial scrutiny of the opinion in *Austin* reveals that it stands in absolute contradiction to the principles set out in *Bellotti*"); Richard L. Hasen, *Justice Souter: Campaign Finance Law's Emerging Egalitarian*, 1 ALB. GOV'T L. REV. 169, 176 (2008) (stating that *Beaumont* "appears to reject" the holding of *Bellotti*); Richard L. Hasen, *Rethinking the Unconstitutionality of Contribution and Expenditure Limits in Ballot Measure Campaigns*, 78 S. CAL. L. REV. 885, 886 (2005) (speculating that ballot initiatives limiting corporate political contributions and expenditures that would have been struck down as unconstitutional in prior decades under *Bellotti*'s reasoning "have a surprisingly good chance of passing muster today"); Bradley A. Smith, *Campaign Finance Reform: Searching for Corruption in All the Wrong Places*, CATO SUP. CT. REV. 187, 217 (2003) (describing *Beaumont* as having "quietly, but not explicitly overruled *First National Bank of Boston v. Bellotti*"); Adam Winkler, *Beyond Bellotti*, 32 LOY. L. REV. 133, 134-36 (1998) (stating that the "conceptual, evidentiary, and theoretical" pillars on which *Bellotti* had rested were "weakened, modified, or supplemented by developments in both judicial doctrine and electoral politics," to the point where they were no longer valid bases for asserting a coherent doctrine for corporate political speech).

40. 459 U.S. at 207-08 (citing *United States v. CIO*, 335 U.S. 106, 113 (1948)).

41. 479 U.S. at 241-42.

economic disincentive for disassociating with [the corporation] if they disagree with its political activity.”⁴²

Both *Austin* and *Beaumont* relied heavily on the reasoning of *MCFL*. In *Austin*, the Court upheld Michigan state prohibitions on corporate independent political expenditures, as applied to the Michigan Chamber of Commerce, a nonprofit corporation with no shareholders. Despite the fact that the Chamber did not have shareholders, the *Austin* Court found that the Chamber’s members were similarly situated to corporate shareholders, in that they might “be similarly reluctant to withdraw as members even if they disagree with the Chamber’s political expression, because they wish to benefit from the Chamber’s nonpolitical programs and to establish contacts with other members of the business community.”⁴³ Thus, relying on the reasoning of *MCFL*, the *Austin* Court found that the Chamber was more like a for-profit corporation whose political expressions might create an “economic disincentive for disassociating with it” than like the non-advocacy corporation at issue in *MCFL*.⁴⁴

In *Beaumont*, the Court upheld prohibitions on corporate direct contributions to political campaigns, as applied to non-profit advocacy corporations. While *Beaumont* does not deal with shareholder protection, it is notable that the *Beaumont* Court justified the structure of campaign finance law—which barred direct corporate contributions but allowed corporations to set up political action committees (PACs) to solicit contributions from employees, stockholders, or members to be used for political activity—in large part based on a shareholder protection rationale.⁴⁵

Bellotti may be understood as standing in part for the proposition that the interest of protecting shareholders from agency conflicts arising from corporate political activity, while valid, is obviated by state corporate law’s existing “procedures of corporate democracy.” Subsequent cases addressing the question of shareholder agency conflicts, from *NRWC* through *Beaumont*, have implicitly rejected *Bellotti*’s proposition that corporate law is sufficient to protect shareholder interests, and thus have found that regulatory restrictions on CPA are justified in part by a shareholder protection rationale. But *Bellotti* and these subsequent cases are consistent insofar as they all recognize the validity of shareholder protection as a basis for regulating corporate political activity.

C. *Citizens United* and Shareholder Protection

The reasoning of *Bellotti* was resurrected and extended in the Court’s 2010 *Citizens United* decision, which invalidated federal prohibitions on “electioneering communications” and strongly affirmed the idea that corporate political expenditures are protected as speech under the First and Fourteenth Amendments.⁴⁶

42. *Id.* at 264.

43. 494 U.S. 652, 663 (1990) (citing *MCFL*, 479 U.S. at 264).

44. *Id.*

45. 539 U.S. 146, 163 (2003) (“The PAC option allows corporate political participation without the temptation to use corporate funds for political influence, quite possibly at odds with the sentiments of some shareholders or members . . .”).

46. 558 U.S. 310 (2010).

Relying essentially on the reasoning of *Bellotti*, *Citizens United* rejected the claim that the government's interest in protecting "dissenting shareholders" justified such prohibitions, on two bases: first, the asserted interest was overinclusive insofar as it would also cover the political communications of media corporations;⁴⁷ and second, echoing *Bellotti*, that there was "little evidence of abuse that cannot be corrected by shareholders 'through the procedures of corporate democracy.'"⁴⁸

Like *Bellotti*, *Citizens United* was met with a strong backlash from corporate law scholars. Much of this scholarship has closely examined the Court's claim that existing "procedures of corporate democracy" sufficiently address shareholder agency conflicts arising from CPA. Of course, not *all* CPA runs against the interests of shareholders. CPA often benefits shareholders, and a good deal of CPA may benefit other stakeholders as well.⁴⁹ But the point that has been raised by corporate law critics of CPA is that the realities of corporate governance—such as the severe information asymmetries between shareholders and managers, the high degree of deference given to corporate insiders by the business judgment rule, and the existence of large collective action and coordination costs—make it difficult for shareholders to effectively manage the conflicts between their interests and those of corporate decision makers, and that these governance issues are especially acute when it comes to CPA, because CPA has the potential to affect the rules of corporate governance themselves.⁵⁰ These corporate governance problems are

47. *Id.* at 361.

48. *Id.* at 362 (quoting *Bellotti*, 435 U.S. 795, at 794 (1978)).

49. Many studies have found a positive relationship between political spending and political favors. See, e.g., Lauren Cohen et al., *Legislating Stock Prices*, 110 J. FIN. ECON. 574 (2013); Michael J. Cooper et al., *Corporate Political Contributions and Stock Returns*, 65 J. FIN. 687 (2010); Kevin B. Grier et al., *The Determinants of Industry Political Activity, 1978-1986*, 88 AMER. POL. SCI. REV. 911 (1994); Randall S. Kroszner & Thomas Stratmann, *Interest-Group Competition and the Organization of Congress: Theory and Evidence from Financial Services' Political Action Committees*, 88 AM. ECON. REV. 1163 (1998); James M. Snyder, Jr., *Campaign Contributions as Investments: The U.S. House of Representatives, 1980-1986*, 98 J. POL. ECON. 1195 (1990); Thomas Stratmann, *Campaign Contributions and Congressional Voting: Does the Timing of Contributions Matter?*, 77 REV. ECON. & STAT. 127 (1995). Many of these favors appear to benefit the corporation receiving them. For example, Richter et al. find that higher levels of political lobbying are closely correlated with lower corporate tax rates, with an average 1% increase in lobbying leading to lower effective tax rates of 0.5% to 1.6% for the average firm. Brian Kelleher Richter et al., *Lobbying and Taxes*, 53 AM. J. POL. SCI. 893, 893-94 (2009). Bonardi et al. find that direct corporate political expenditures are associated with better regulatory outcomes (in enforcement, adjudicatory, and rulemaking actions) for regulated utilities. Jean-Philippe Bonardi et al., *Nonmarket Strategy Performance: Evidence from U.S. Electric Utilities*, 49 ACAD. OF MGMT. J. 1209, 1218 (2006). Goldman et al. find that corporate political activity—specifically, the political connections of board members of publicly traded companies—is significantly correlated with the procurement of government contracts. Eitan Goldman et al., *Politically Connected Boards of Directors and the Allocation of Procurement Contracts*, 17 REV. FIN. 1617, 1617-18 (2013). Thus, it seems that corporate political spending does lead to some benefits, although it's not entirely clear who receives these benefits. The empirical evidence on whether CPA benefits shareholders is somewhat mixed, see *infra* notes 53 and 54. But regardless of whether CPA actually benefits shareholders or not, it would seem that, at least in theory, the positive value that typically accompanies CPA can accrue to all corporate stakeholders, and not just to corporate insiders or shareholders.

50. See, e.g., Bebchuk & Jackson, Jr., *supra* note 1; Brudney, *supra* note 32; Carol R. Goforth, "A Corporation Has No Soul"—*Modern Corporations, Corporate Governance, and Involvement in the Political Process*, 47 HOUS. L. REV. 617 (2010); Thomas W. Joo, *The Modern Corporation and Campaign Finance: Incorporating Corporate Governance Analysis into First Amendment Jurisprudence*, 79 WASH. U. L.Q. 1, 80 (2001); Stefan J. Padfield, *The Silent Role of Corporate Theory in the Supreme Court's Campaign Finance Cases*, 15 J. CONST. L. 831, 835-43

exacerbated in today's global capital markets, where most shares of large publicly traded companies are owned by intermediaries (such as mutual funds and pension funds) rather than directly held by individual shareholders, creating another layer of agency costs.⁵¹

Given that CPA can potentially lead to high agency costs for shareholders, a key question is whether, as the Supreme Court has asserted in *Bellotti* and *Citizens United*, existing "procedures of corporate democracy" sufficiently address these agency conflicts, and this has been the subject of a robust debate in the literature. CPA is governed by the same rules of corporate governance as general business activities,⁵² and as discussed *infra* in Part II, there has been much research on the question of whether corporate law—and its fealty to the principles of shareholder primacy—solves the agency problems between shareholders and corporate insiders. Thus, it is not surprising that there is a similar debate over the question of whether, and to what extent, corporate political activity is good for shareholders. A growing body of empirical research has looked into this question, with many scholars finding that CPA harms shareholders,⁵³ and others finding that CPA benefits

(2013); Elizabeth Pollman, *Reconceiving Corporate Personhood*, 2011 UTAH L. REV. 1629 (2011); Robert B. Sobelman, *An Unconstitutional Response to Citizens United: Mandating Shareholder Approval of Corporate Political Expenditures*, 77 BROOK. L. REV. 341 (2011); Robert Sprague & Mary Ellen Wells, *The Supreme Court as Prometheus: Breathing Life into the Corporate Supercitizen*, 49 AM. BUS. L.J. 507 (2012); Anne Tucker, *Flawed Assumptions: A Corporate Law Analysis of Free Speech and Corporate Personhood in Citizens United*, 61 CASE W. RES. L. REV. 497, 533 (2010) (pointing out that shareholder suits against corporate waste must survive the wide latitude of the business judgment rule); Elizabeth Pollman, *Citizens Not United: The Lack of Stockholder Voluntariness in Corporate Political Speech*, 119 YALE L.J. ONLINE 53, 56-57 (2009) (pointing out how severe information asymmetries between corporate insiders and outside shareholders make it difficult for shareholders to monitor the political activities of the corporation, and collective action problems make it difficult for them to utilize the procedures of corporate democracy effectively).

51. See Jordan M. Barry et al., *On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership*, 99 VA. L. REV. 1103 (2013); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Jennifer S. Taub, *Money Managers in the Middle: Seeing and Sanctioning Political Spending After Citizens United*, 15 N.Y.U. J. LEGIS. & PUB. POL'Y 443 (2012).

52. Bebchuk & Jackson, Jr., *supra* note 1, at 83 ("Under existing law, a corporation's decision to engage in political speech is governed by the same rules as ordinary business decisions, which give directors and executives virtually plenary authority.").

53. See, e.g., Rajesh K. Aggarwal et al., *Corporate Political Donations: Investment or Agency*, 14 BUS. & POL. 1 (2012) (finding a negative relationship between corporate political donations and annual returns); Bebchuk & Jackson, Jr., *supra* note 1 (exploring the structural difficulties that minority shareholders face in addressing agency problems for CPA); Coates, *supra* note 1 (finding that politically active corporations experience a decline in share value); Jill E. Fisch, *How Do Corporations Play Politics?: The FedEx Story*, 58 VAND. L. REV. 1495 (2005); Thomas W. Joo, *The Modern Corporation and Campaign Finance: Incorporating Corporate Governance Analysis into First Amendment Jurisprudence*, 79 WASH. U. L.Q. 1, 80 (2001); Robert Sitkoff, *Politics and the Business Corporation*, 26 REG. 30 (2003-04); Timothy Werner & John J. Coleman, *Citizens United, Independent Expenditures, and Agency Costs: Reexamining the Political Economy of State Antitakeover Statutes*, 31 J.L. ECON. & ORG. 127, 129-30 (2014) (finding that state legislatures are more likely to pass antitakeover statutes, which protect management against outside shareholders, when corporations are unrestricted in their corporate political expenditures, suggesting significant shareholder agency costs in this regard); Winkler, *supra* note 19; Hollis A. Skaife & Timothy Werner, *Deregulation of Firm Investments Under Citizens United and Firm Value* (2014) (unpublished working paper) (finding that firms with high levels of political activity prior to *Citizens United* generally saw abnormally negative returns following the decision, suggesting high shareholder agency costs). *But see* Stephen Ansolabehere

shareholders.⁵⁴ One important reason why there is such a lack of consensus, despite the large amount of research into this question, is that “[u]nlike other investments, the return on engaging in the political process is difficult, if not impossible, to calculate.”⁵⁵

This divide in the literature matches up neatly with the opposition between Justice Kennedy’s majority opinion and Justice Stevens’s dissent in *Citizens United* over this same shareholder agency cost question. One of the government’s primary arguments in that case was that campaign finance regulations were justified based on a shareholder protection rationale.⁵⁶ As aforementioned, the majority rejected this argument on the basis of its observation that there is “little evidence of abuse that cannot be corrected by shareholders ‘through the procedures of corporate democracy.’”⁵⁷ Conversely, the dissent argued that these “procedures of corporate democracy” are actually “so limited as to be almost nonexistent,” and concluded that these agency problems are therefore quite large.⁵⁸

Does corporate law bridge the shareholder-manager agency conflicts that may arise from CPA? In short, while the empirical answer may be up for debate, the legal answer is clear. The majority in *Citizens United* decisively declared that the existing procedures of corporate governance—and the shareholder primacy norm that are reflected in them—are sufficient to address any shareholder agency problem that might exist.

II. Agency Costs and Corporate Law

While the debate over corporate political activity has revolved exclusively around shareholder agency costs, corporate law has long recognized that there are many other types of agency relationships—and resulting agency costs—within the modern public corporation. While shareholder interests are still emphasized in

et al., *Did Firms Profit From Soft Money?*, 3 ELECTION L.J. 193 (2004) (finding no relationship between corporate expenditures on political campaigns and stock price).

54. Shapiro and Dowson have a good summary of the literature finding that CPA benefits shareholder interests. SHAPIRO & DOWSON, *supra* note 1. Cooper et al. find a positive relationship between CPA and returns on equity. Cooper et al., *supra* note 49. Yuan finds that corporations with a long history of corporate political contributions saw an increase in share price following Supreme Court decisions that deregulated campaign finance restrictions, suggesting that shareholders saw benefits in CPA. Haishan Yuan, *Court-Ordered Campaign Finance Deregulation and Stock Value of Contributors*, 17 AM. L. & ECON. REV. 1 (2015). However, Ansolabehere et al. find no relationship between corporate political expenditures and corporate long-term earnings. Ansolabehere et al., *supra* note 53. Chen et al. have a somewhat more nuanced finding, concluding that the firms that engage in the highest level of lobbying expenditures do see abnormally high returns of 5.5% over their peers, but that firms engaged in less intensive lobbying do not experience improved performance. Hui Chen et al., *Corporate Lobbying and Firm Performance*, 42 J. BUS. FIN. & ACCT. 444, 472 (2015).

55. Felix Oberholzer-Gee et al., *Note on Lobbying* 1 (Harvard Bus. Sch. Background Note 707-471, 2007).

56. Supplemental Reply Brief for the Appellant at 6-7, *Citizens United v. FEC*, 558 U.S. 310 (2010) (No. 08-205); see also Richard Hasen, *Citizens United and the Orphaned Antidistortion Rationale*, 27 GA. ST. UNIV. L. REV. 989 (2010) (describing how the government abandoned one of the key rationales for restricting corporate political activities, and “recast” it as a shareholder protection rationale).

57. 558 U.S. at 361-62.

58. *Id.* at 476-77 (Stevens, J., concurring in part and dissenting in part) (quoting Blair & Stout, *supra* note 4, at 320).

corporate theory, it is not because shareholders are the only corporate constituents who face agency costs, but rather because, as I explain in this Part, it is thought that their agency costs are the most intractable.

This Part begins by situating agency costs in corporate law, and describing the nexus-of-contracts approach to corporate law. It describes the various agency costs faced by the two most important non-shareholder groups of corporate constituents—creditors and employees. It then lays out the contractarian case for prioritizing shareholder interests despite the presence of significant non-shareholder agency costs.

A. Situating Agency Costs in Corporate Law

Agency costs have been a central focus of corporate law scholarship since at least 1932, when Adolf Berle and Gardiner Means identified the separation of ownership and control as the central feature of the modern American public corporation.⁵⁹ As Berle and Means noted, this separation of the corporation's ownership from its control "produces a condition where the interests of owner and of ultimate manager may, and often do, diverge."⁶⁰ This agency conflict inherent to the corporate structure has occupied the attention of modern corporate law scholars ever since.

For several decades after Berle and Means unveiled their influential thesis on the corporation, the agency problem embedded in corporate governance was primarily understood as a relatively simple principal-agent conflict between shareholders, who were viewed as the outside owners of the corporation, and corporate managers, who were seen as the agents of these shareholders.⁶¹ However, even at the time of Berle and Means, there were many who asserted that the corporation was a more complex structure than this simple principal-agent model between shareholders and managers might suggest. As Berle and Means themselves noted, many of their contemporaries considered other corporate interest holders, including creditors and even employees, to be part owners of the corporation.⁶² Indeed, in a widely read 1932 treatise, Merrick Dodd, a highly respected corporate

59. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 113-16, 310-13 (10th prtg. 2009) (1932).

60. *Id.* at 7.

61. As the prominent corporate law scholar Merrick Dodd noted, "The conception of a business corporation as the property of its shareholders is deeply rooted both in our legal and our economic traditions [I]t is our lawyer's theory, as well as the business man's tradition, that the business corporation is an association of shareholders conducted for the profit of shareholders, and that, if the corporation owns the business, the shareholders in turn own the corporation." E. Merrick Dodd, Jr., *The Modern Corporation, Private Property, and Recent Federal Legislation*, 54 HARV. L. REV. 917, 917-18 (1941); see also Merrick E. Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1146 (1932) [hereinafter Dodd, Jr., *For Whom Are Corporate Managers Trustees?*] ("The business is still a private enterprise existing for the profit of its owners, who are now the shareholders."); J.A.C. Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248, 250 (1969) ("The legal conception of the shareholder's position in the corporation has not changed appreciably during the past 70 years. In a word, he is the owner of the company, possessed of the legal attributes generally associated with that status In the corporate context the law generally follows economic theory by giving the shareholder—as owner—control over the business enterprise.").

62. BERLE & MEANS, *supra* note 59, at 113.

law scholar who was seen as a principal foil to Berle and Means, went so far as to argue that the corporation owed a fiduciary responsibility not just to its shareholders but also to its employees and customers.⁶³

Over time, the idea that shareholders “owned” the corporation became increasingly seen as both theoretically flawed and descriptively inaccurate. Rather, the dominant view among corporate law scholars today is closer to the minority view put forth by Dodd and others back in the 1930s—that the public corporation is better understood as an aggregation of different economic inputs from shareholders, creditors, employees (including managers and non-managerial workers), directors, suppliers, and other corporate stakeholders. It was this, more nuanced, understanding of the corporation that undergirded Michael Jensen and William Meckling’s canonical 1976 argument that the corporation should be seen as a “nexus of contracts” between its many different stakeholders. Building off of Ronald Coase’s theory that the firm exists to minimize transaction costs,⁶⁴ Jensen and Meckling asserted that modern corporations are best understood as “legal fictions which serve as a nexus for a set of contracting relationships” between investors, managers, employees, suppliers, and consumers.⁶⁵ Under this “contractarian” view, the corporation exists primarily to minimize the significant transaction costs that would arise if each of these sets of counterparties were to contract separately with one another. But while the corporation may serve to minimize these transaction costs, it also creates myriad agency relationships.⁶⁶ Embedded in each of these different contractual (or quasi-contractual) relationships

63. Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, *supra* note 61, at 1145.

64. R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). While Coase himself was somewhat vague about what transaction costs were, a significant body of subsequent work has defined the contours of this concept. Transaction costs, which are roughly defined as the costs of contracting, include information costs, negotiating costs, the cost of writing contracts, and the costs of enforcing contractual terms. As Williamson famously showed, transaction costs may be most severe when economic actors make investments specific to the relationship, such as when an electricity plant is built near a coal mine that is meant to supply it, or a worker undergoes extensive training to learn to operate a specific set of machinery. OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 52-56 (1985). Such investment produces a form of “quasi rent” that can be captured by one set of economic actors, such as when the coal company threatens to stop supplying the nearby power plant unless it receives a significant price increase. See Benjamin Klein et al., *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297, 298-302 (1978). This creates the potential for unproductive rent seeking between the firm’s stakeholders, which is often carried out through post-contractual opportunism. *Id.*

65. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 310 (1976). This “nexus of contracts” view of the corporation has since been adopted and extended by countless corporate governance and corporate finance scholars. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 292-93 (2d ed. 1977); Steven Cheung, *The Contractual Nature of the Firm*, 25 *J.L. & ECON.* 301 (1983); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 *COLUM. L. REV.* 1416 (1989); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J.L. & ECON.* 301 (1983); Daniel R. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 *U. CHI. L. REV.* 1061 (1984); Oliver Hart, *An Economist’s Perspective on the Theory of the Firm*, 89 *COLUM. L. REV.* 1757 (1989); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective*, 84 *CORNELL L. REV.* 1266 (1999); Oliver Williamson, *Corporate Finance and Corporate Governance*, 43 *J. FIN.* 567 (1988); Oliver Williamson, *Corporate Governance*, 93 *YALE L.J.* 1197 (1984).

66. Jensen & Meckling, *supra* note 65, at 308.

is such an agency relationship, along with the agency conflicts that this type of relationship presents.⁶⁷ Thus, while the contractarian view of the corporation derives from transaction cost theory, it emphasizes agency conflicts, as it focuses on the conflicting interests between the different stakeholders connected to the corporate “nexus” at the center of these contractual and quasi-contractual relationships.⁶⁸

One of the key insights of Jensen and Meckling was to recognize that the problem of agency relationships within the corporation, which had previously been studied almost exclusively as a shareholder-manager issue, actually extends to a much broader range of contractual (and quasi-contractual) relationships, including those involving employees, suppliers, customers, and creditors, among others.⁶⁹ Jensen and Meckling characterized the negative consequences of these agency conflicts as “agency costs,” which they defined as the sum of the monitoring and bonding costs incurred to ensure that the agent acts in the principal’s best interests, along with any residual loss that occurs because the agent nonetheless acts in ways that are adverse to those interests.⁷⁰ Jensen and Meckling’s “nexus of contracts” approach and the agency cost framework that accompanies it have come to dominate corporate law thinking over the last several decades.⁷¹

Before continuing, it is worth taking a few moments to explain the relationship between agency costs, theories of the firm, and theories of corporate law. As one scholar has stated, “There is some confusion in legal scholarship about the relationship between the principal-agent framework and the theory of the firm.”⁷² Agency theory is an analytical tool used to study various problems across a wide array of disciplines.⁷³ It has had a strong influence in scholarship about the theory

67. *Id.* at 310.

68. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 634-35 (2004); Jensen & Meckling, *supra* note 65, at 310.

69. Jensen & Meckling, *supra* note 65, at 310.

70. *Id.* at 308-10. While monitoring costs and residual loss are relatively straightforward concepts, the idea of bonding expenditures may benefit from a brief explanation. Jensen and Meckling posit that, in a hypothetical contract, the principal may seek to provide contractual terms and guarantees that more closely align (“bond”) the manager’s incentives with those of the principal. *Id.* at 325-26. In practice, bonding expenditures most commonly take the form of incentives, particularly incentive-based compensation. See generally Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

71. While there have been a number of prominent critiques of the nexus-of-contracts approach, even these critiques have tended to acknowledge the broad adoption of the contractarian view among academics, judges, and practitioners. See, e.g., Margaret M. Blair, *Corporate Law and the Team Production Problem*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 33, 34 (Claire A. Hill & Brett H. McDonnell eds., 2012) (stating that the Jensen and Meckling view “dominated corporate law and economics scholarship in the 1980s and 1990s, and continues to be influential today”); Matthew T. Bodie, *Employees and the Boundaries of the Corporation*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 85, 85 (Claire A. Hill & Brett H. McDonnell eds., 2012) (stating that the “nexus of contracts” approach “remains foundational in the field [of corporate law]”).

72. Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 728 (2004).

73. Agency models are used to study a wide array of topics in law and economics besides the theory of the firm, including contracts law, intellectual property, and administrative law. See, e.g., *Agency Models in Law and Economics*, in CHICAGO LECTURES IN LAW AND ECONOMICS (Eric A. Posner ed. 2000). They are also used to study problems in accounting, finance, marketing, political

of the firm—why firms exist, what determines the boundaries of the firm, and how firms should be organized.⁷⁴ But agency theory is one of several different analytical frameworks used in developing theories of the firm.⁷⁵

While there are a number of different theories of the firm, only several have had significant impact on corporate law.⁷⁶ Many leading theories of the firm, such as the property-rights theory developed by Grossman, Hart, and Moore,⁷⁷ the incomplete contracts theory posited by Williamson,⁷⁸ or Rajan and Zingales's "access" theory of the firm,⁷⁹ have failed to gain much traction in the corporate law literature.⁸⁰

While agency theory might accurately be described as influential in theory of the firm, it has been a primary focus of corporate law scholarship. As several leading corporate law scholars have stated:

[M]uch of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies, including creditors and employees. All three of these generic conflicts may usefully be characterized as . . . 'agency problems.'⁸¹

Two theories of the firm that have attracted significant attention in corporate law, in addition to the nexus-of-contracts approach, are the stakeholder and team production models. The stakeholder model is often attributed to the business management scholar R. Edward Freeman,⁸² but its roots go back at least as early as Merrick Dodd's arguments against shareholder wealth maximization in 1932, and

science, and sociology, among others. See Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 57 (1989).

74. Meurer, *supra* note 72, at 728.

75. See Eisenhardt, *supra* note 73, at 63-64. As Eisenhardt describes, other frameworks used to examine the theory of the firm include political models, the informational processing approaches to contingency theory, organizational control theory, and transaction cost theory. *Id.* Other approaches include team production theory, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); stakeholder theory, see R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* (1984); and property rights theory, see Oliver D. Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

76. See Matthew T. Bodie, *The Post-Revolutionary Period in Corporate Law: Returning to the Theory of the Firm*, 35 SEATTLE U. L. REV. 1033, 1039 (2012) (stating that "[r]esearch on the theory of the firm . . . has been relatively unplumbed in corporate law").

77. See OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

78. See WILLIAMSON, *supra* note 64.

79. Raghuram Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998).

80. See Bodie, *supra* note 76, at 1040-45.

81. John Armour et al., *The Essential Elements of Corporate Law: What is Corporate Law?*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 1, 3 (2009).

82. R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* (1984).

arguably back to the origins of the corporation itself.⁸³ In recent years, the stakeholder model of the corporation has been most closely tied to Kent Greenfield, a law professor at Boston College.⁸⁴ This model rejects the idea of shareholder primacy and instead asserts that “all persons or groups with legitimate interests participating in an enterprise do so to obtain benefits and that there is no *prima facie* priority of one set of interests and benefits over another.”⁸⁵

The team production theory has its origins in the work of Armen Alchian and Harold Demsetz, who analyzed the problems posed when there is joint or team production by various actors who combine their efforts in the hopes of increasing productivity beyond the sum of their individual efforts.⁸⁶ Margaret Blair and Lynn Stout famously utilized this theory to articulate their team production theory of corporate law.⁸⁷ They argued that the corporation serves as a “mediating hierarchy” that addresses the team production problems identified by Alchian and Demsetz by requiring the various “team members” of the corporation (including shareholders, managers, employees, and creditors) to give up control of their investments in the firm in order to minimize the potential conflicts among the team members that might otherwise arise.⁸⁸ Under this view, shareholder interests should not be prioritized any more than the interests of other team members.

It should be noted that both of these models of the corporation are consistent with agency theory. Indeed, stakeholder theory is often seen as an outgrowth of traditional agency theory, and some advocates of the stakeholder model have expressly conceptualized stakeholder theory within the context of agency costs.⁸⁹ Team production theory, on the other hand, contends that mainstream corporate law’s focus on agency costs is myopic and ignores the significant team production issues presented by cooperative endeavors between different parties who contribute some kind of firm-specific investment.⁹⁰ But while advocates of team production

83. For much of its history, the corporation was understood as an organizational form that was granted by the state and which owed its existence to the state. *See generally* Reuven S. Avi-Yonah, *The Cyclical Transformation of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 DEL. J. CORP. L. 767 (2005) (describing the longstanding view of the corporation as deriving its authority and existence from the state, from its origins in Roman law through the middle ages and into the late 19th century). This “concession” or “artificial entity” theory of the corporation asserts that the corporation owes a duty first and foremost to the state and its citizens. It may be seen as consistent with the stakeholder theory, insofar as both theories may be viewed as “communitarian” theories of the firm. *See, e.g.*, Benedict Sheehy, *Scrooge—The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate*, 14 U. MIAMI BUS. L. REV. 193, 230-31 (2005).

84. *See, e.g.*, Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL’Y REV. 1, 24 (2008) (proposing that all important stakeholders in the corporation, including employees, communities, long-term business partners, and creditors be represented on the corporate board).

85. Thomas Donaldson & Lee Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. OF MGMT. REV. 65, 68 (1995).

86. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

87. Blair & Stout, *supra* note 4.

88. *Id.* at 250-55, 273-79.

89. *See, e.g.*, Charles W.L. Hill & Thomas M. Jones, *Stakeholder-Agency Theory*, 29 J. MGMT. STUD. 131, 132 (1992).

90. *See* Blair & Stout, *supra* note 4.

theory may believe that agency costs are overemphasized, they do not contend that agency costs are an unimportant problem in corporate governance.⁹¹

Both the stakeholder and team production models have been quite influential and are arguably quite convincing normative theories of corporate law. If we adopted either model, it would be clear that non-shareholder interests should be closely considered by managers and directors, not only with respect to their decisions to engage in corporate political activity, but for all business decisions. However, while these theories may be theoretically compelling, they have not been widely adopted by practitioners, policy makers, or judges, who have tended to view corporate law as prioritizing the interests of shareholders over those of other corporate stakeholders (or team members).⁹²

Importantly for the purposes of this Article, these alternative theories of corporate law have generally been ignored by the Supreme Court. For example, in *Citizens United*, while Justice Stevens's dissent explicitly disavows the adoption of any particular model of the corporation,⁹³ it is telling that both his dissent⁹⁴ and Justice Kennedy's majority opinion⁹⁵ focus exclusively on the rights and interests of shareholders, and not on those of other corporate stakeholders. This emphasis on shareholder rights is consistent with the Court's previous reasoning in *Bellotti*,⁹⁶ in which the Court looked solely to the rights of shareholders and ignored the interests of other corporate stakeholders. The failure to consider the interests of other corporate stakeholders is also reflected in the corporate law literature on corporate political activity, which, as I describe *supra* in Part I, has to date looked solely at the agency costs such activity poses to shareholders.

B. Contractarianism and Non-Shareholder Agency Costs

As aforementioned, one of the central insights of Jensen and Meckling was to recognize the importance of agency conflicts faced by non-shareholders.

91. *Id.*; see also Ron Harris, *The History of Team Production Theory*, 38 SEATTLE U. L. REV. 537, 538 (2015) (contending that team production theory and agency theory "are designed to solve different problems, and, therefore, can coexist in different types of corporations").

92. See Leo J. Strine, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 453-55 (2014) (noting that "[i]n American corporate law, only stockholders get to elect directors, vote on corporate transactions and charter amendments, and sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties," and that "this allocation of power has a profound effect" in elevating the interests of shareholders over the interests of others).

93. 558 U.S. 310, 465 n.72 (2010) (Stevens, J., concurring in part and dissenting in part) ("Nothing in this analysis turns on whether the corporation is conceptualized as a grantee of state concession[,] . . . a nexus of explicit and implicit contracts[,] . . . a mediated hierarchy of stakeholders[,] . . . or any other recognized model").

94. *Id.* at 475-78.

95. *Id.* at 361-62.

96. 435 U.S. 765 (1978). The *Bellotti* Court specifically noted that the protection of dissenting shareholders is "an interest that is both legitimate and traditionally within the province of state law." *Id.* at 792. But it rejected the state's regulation of corporate political expenditures (meant to sway public opinion on a ballot initiative), in large part based on the Court's view that "shareholders normally are presumed competent to protect their own interests," *id.* at 795, by utilizing "the procedures of corporate democracy," *id.* at 794, such as by electing directors, insisting upon protective provisions in the corporate charter, or filing derivative suits.

Envisioning the corporation as a web of contractual relationships between different corporate stakeholders makes clear that each of these sets of stakeholders—not just the shareholder class—faces potentially significant agency costs in its dealings with the corporation. Like shareholders, non-shareholders invest their resources in the corporation and thus have reason to care that the firm is being managed in their interest, but face high costs and difficulties in ensuring that this happens.

Moreover, the success of shareholder primacy advocates in convincing the business world, the business law bench, and the academy of the merits of adopting the “religion” of shareholder primacy has exacerbated the agency costs faced by non-shareholders.⁹⁷ As shareholder-centrism has become internalized in corporate law and corporate governance, non-shareholders are faced with an additional layer of agency costs. Non-shareholders have to worry about agency costs vis-à-vis corporate insiders *and* also vis-à-vis corporate shareholders. Whether corporate decision makers are acting in their own interests or in the interests of shareholders, either scenario can create potential agency costs for non-shareholders. This new “shareholder-centric reality,” as Edward Rock has described the current state of corporate law, has caused many corporate law scholars to look more closely at the agency costs faced by non-shareholders.⁹⁸

The two largest and most important non-shareholder constituencies are generally thought to be creditors and employees.⁹⁹ The agency costs faced by these non-shareholder groups have therefore received the most attention from corporate law scholars. As such, I focus on these particular non-shareholder groups in this Article, although many of the observations and conclusions I make may also be applicable to other non-shareholder groups, such as consumers or suppliers. The observations below are general ones, in large part because “[a]gency costs can rarely be observed directly.”¹⁰⁰

1. Creditor Agency Costs

In many ways, the distinction between shareholders and creditors has been rendered obsolete by the globalization of capital markets, the invention (and constant reinvention) of structured finance, and the universal adoption of portfolio

97. As one *Businessweek* article in 2010 memorably stated, “If business school were church, shareholder value maximization would be its religion.” N. Craig Smith & Luk Van Wassenhove, *How Business Schools Lost Their Way*, BUSINESSWEEK, Jan. 11, 2010, <http://www.bloomberg.com/bw/stories/2010-01-11/how-business-schools-lost-their-way> businessweek-business-news-stock-market-and-financial-advice.

98. See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1917-23 (2013).

99. See John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495, 1499 (1990) [hereinafter Coffee, *Unstable Coalitions*] (“The two largest [non-shareholder] constituents . . . are creditors and employees.”). It is also worth noting that there can be significant agency costs between employees and creditors, particularly when a firm is in or near insolvency. See generally Bradley Blaylock et al., *The Role of Government in the Labor-Creditor Relationship: Evidence from the Chrysler Bankruptcy*, 50 J. FIN. & QUANTITATIVE ANALYSIS 325 (2015) (analyzing the role of government in the labor-creditor relationship when a firm is in distress).

100. Rock, *supra* note 98, at 1916.

theory and quantitative portfolio management.¹⁰¹ The increased use of credit derivatives, including synthetic derivatives, has also made this distinction largely moot.¹⁰² As Frank Partnoy convincingly demonstrates, options can (and do) negate the economic differences between the rights held by shareholders and creditors, making it difficult to assess both who is owed a fiduciary duty and what this fiduciary duty comprises.¹⁰³ At the same time, as Jordan Barry describes, derivatives (including options) can separate voting rights from economic interests, thus creating “empty voters” (those holding voting rights without an economic stake in the firm) and “hidden owners” (those holding economic interests without a voting stake in the firm).¹⁰⁴ Similarly, derivatives can decouple the creditor’s ability to influence corporate governance from the creditor’s economic interest.¹⁰⁵

That being said, it is clear that creditors are treated differently under corporate law and cannot generally expect to rely on fiduciary duties or other governance measures to protect their interests. Like employees, creditors face sharp frictions in their dealings with the corporation, both with respect to managers and shareholders.¹⁰⁶ Of course, managers acting in their own self-interest can pose an agency problem for creditors. But creditors also face additional agency costs, to the

101. As Baird and Henderson, among others, have noted, the use of call and put options to limit the floor and ceiling of investor gains and losses, which has been “going on for a long time,” effectively eliminates the differences between debt and equity from the perspective of the investor. Douglas G. Baird & M. Todd Henderson, *Other People’s Money*, 60 STAN. L. REV. 1309, 1311-12 (2008). The development of modern financial products such as synthetic derivatives has also rendered the differences between debt and equity largely moot. *Id.* at 1311-12.

102. See Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 608 (2000); Yesha Yadav, *The Case for a Market in Debt Governance*, 67 VAND. L. REV. 771, 773 (2014).

103. Partnoy, *supra* note 102, at 608-28.

104. Barry et al., *supra* note 51, at 1104; see also Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 787-804 (2005) (describing the same problem as one of “encumbered shares”).

105. See generally Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663 (2008) (analyzing the risks associated with unbundling economic and legal rights); Yadav, *supra* note 102, at 775-76 (analyzing how credit default swaps separate economic risk and legal rights). Lubben and Tung also discuss how credit derivatives can incentivize creditors to act against the best interests of debt investors generally. Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 423-27 (2007); Tung, *supra* note 7, at 167-69.

106. As with shareholders, creditors are a very heterogeneous group. The usual taxonomy of corporate debt divides it into two categories—private debt, which includes direct loans and traditional private placements of bonds, and public debt, which encompasses publicly offered corporate bonds. See Yakov Amihud et al., *A New Governance Structure For Corporate Bonds*, 51 STAN. L. REV. 447, 456-57 (1999); Matteo Arena, *The Corporate Choice Between Public Debt, Bank Loans, Traditional Private Debt Placements, and 144A Debt Issues*, 36 REV. QUANTITATIVE FIN. & ACCT. 391, 391-94 (2011); Simon H. Kwan & Willard T. Carleton, *Financial Contracting and the Choice Between Private Placement and Publicly Offered Bonds*, 42 J. MONEY, CREDIT & BANKING 907, 907-11 (2010). There are also bonds that are privately placed under SEC Rule 144A. These 144A bonds are sometimes referred to as private debt. See, e.g., David J. Denis & Vassil T. Mihov, *The Choice Among Bank Debt, Non-Bank Private Debt, and Public Debt: Evidence from New Corporate Borrowings*, 70 J. FIN. ECON. 3 (2003). But perhaps because they are widely dispersed and traded, 144A bonds more closely resemble public debt in many ways, including their underwriting characteristics and terms (such as a lack of covenants). Amihud et al., *supra*, at 456 n.32. Private debt and public debt have distinct characteristics, and thus there are different types of agency costs and contracting costs associated with the creditors in each category. I discuss some of these differences in greater detail in Part IV.

extent that managers may also be acting in the best interests of shareholders. It is well recognized that equity investors have interests that are distinct from, and often adverse to, the interests of debt investors.¹⁰⁷ This is particularly true when it comes to their relative tolerances for risk. As one leading economist has stated, “Equity holders have a more complex attitude towards firm risk [than creditors]. Equity holders have both upside potential, if the firm prospers, and downside potential, if the firm fails.”¹⁰⁸ Edward Rock describes this “shareholder-creditor agency cost” problem slightly differently, asserting that the core of this conflict lies in the fact that “shareholders, holding the residual claim on the firm, have an incentive to externalize risk onto creditors and other fixed claimants.”¹⁰⁹

There are a number of different ways in which firms can externalize risk onto creditors for the benefit of shareholders.¹¹⁰ They can increase the riskiness of the projects they undertake. As Robert Merton famously showed, when corporations invest in assets or projects with higher volatility, this increases both the value of the firm’s equity and the default risk for creditors.¹¹¹ Amihud et al. illustrate this concept with a simple example:

Consider a company with \$100 in cash (and no other assets) and \$80 in short-term debt, so the debt is currently worth about \$80 and the stock is worth \$20. If the company invested all of its cash in a project with a 50% chance of yielding \$10 and a 50% chance of yielding \$150, shareholders would benefit—the [expected] value of the equity would increase from \$20 to \$35—and creditors would be hurt—the value of the debt would decline from \$80 to \$45. More significantly, the value of the company as a whole would decline from \$100 to \$80.¹¹²

Corporations can also benefit shareholders while harming creditors in other ways. They can direct assets to shareholders through higher dividend payments.¹¹³ They can refrain from adding new equity, even when this capital could be deployed

107. See, e.g., Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (describing some of the contractual covenants used by debt investors to help control this misalignment of interests). Moreover, as Richard Squire notes, the problem of shareholder influence is also exacerbated by the problem of “correlation-seeking,” insofar as they may seek to encourage risks that only materialize upon the event of an uncertain future event. Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1153 (2010).

108. Robert R. Bliss, *Market Discipline: Players, Processes and Purposes*, in MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES 37, 43 (Claudio Borio et al. eds., 2004).

109. Rock, *supra* note 98, at 1927.

110. See William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 EUR. BUS. ORG. L. REV. 39, 43-47 (2006) [hereinafter Bratton, *Bond Covenants*]; Smith & Warner, *supra* note 107, at 118-19.

111. Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 455-67 (1974). Merton uses the Black-Scholes model of option pricing to reach his conclusions. *Id.* But see Bliss, *supra* note 108, at 43-44 (arguing that the use of the Black-Scholes model is overly simplistic, and that share prices should theoretically also consider the reduced value of future dividends and increased cost of funding that accompanies higher default risk).

112. Amihud et al., *supra* note 106, at 454 (footnotes omitted); see also *id.* at 454 nn.20-22.

113. See Rock, *supra* note 98, at 1929. See also *Geren v. Quantum Chem. Corp.*, 823 F. Supp. 728, 730 (S.D.N.Y. 1993) (describing a bondholder complaint that the defendant corporation had borrowed \$1.221 billion to pay a special dividend to shareholders, causing shareholder equity to drop to negative \$406 million and the market value of the outstanding bonds to drop by half).

to projects with positive value.¹¹⁴ They can increase leverage, which can cause harm to creditors in various ways. As the surge in leveraged buyouts (LBOs) in the 1980s illustrated, the use of increased debt, such as junk bonds, can finance acquisitions at higher share prices, but the addition of large amounts of short-term debt increases the risk of default for longer-term creditors.¹¹⁵ Firms can also add debt that is senior or equal in priority to the debt that is outstanding, thus effectively displacing the priority of existing creditors and increasing their risk of loss.¹¹⁶ LBOs generally provide large benefits to shareholders¹¹⁷ while causing significant losses to creditors.¹¹⁸

The problem of creditor agency costs has increased as corporate managers have become more shareholder-centric in their priorities. Since the 1980s, changes in managerial compensation, shareholder concentration and activism, and board composition and ideology have served to more closely align the interests of corporate managers and shareholders.¹¹⁹ These changes include the increased use of equity-based compensation for corporate managers, the reduced use of staggered boards, smaller boards of directors with more frequent meetings, and the use of “say on pay” provisions allowing shareholders to voice their disapproval of manager compensation packages, among other things. The trend towards aligning the interests of shareholders and managers has had the effect of decreasing agency costs between these two constituencies, but it has come at the expense of increasing creditor-manager and creditor-shareholder agency costs. This is true not only theoretically, but empirically as well. Corporations with structural features that more closely align the interests of management and shareholders, such as equity-based compensation or managerial ownership, have higher bond yields than those that do not.¹²⁰ Bank debt exhibits the same phenomenon, as corporations that are

114. See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 152-60 (1977); Rock, *supra* note 98, at 1927.

115. See Coffee, *Unstable Coalitions*, *supra* note 99, at 1499-1519.

116. See Rock, *supra* note 98, at 1927.

117. See Khalil M. Torabzadeh & William J. Bertin, *Leveraged Buyouts and Shareholder Returns*, 10 J. FIN. RES. 313, 313-19 (1987) (finding that stockholders of corporations acquired through successful LBOs from 1982-1985 received significant positive returns).

118. See Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts*, 6 REV. FIN. STUD. 959, 979 (1993) (finding that nonconvertible “bondholders experienced significant wealth losses in successful LBOs of the 1985-1989 period” and that these were representative of debt losses across the corporate financing structure). One prominent example of how LBOs provide a windfall to shareholders while harming creditors was seen in the successful LBO of RJR Nabisco in 1989. Following the announcement that RJR Nabisco would be acquired by KKR for a price of \$109/share (a massive premium over the share price before RJR began publicly soliciting LBO bids), the senior unsecured bonds issued by RJR were downgraded from the investment grade ratings that they had held. See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1505-1513 (S.D.N.Y. 1989).

119. Bratton and Wachter, and Rock, have good summaries of the efforts to improve corporate governance by better aligning the interests of shareholders and managers. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 669-75 (2010); Rock, *supra* note 98, 1911-26 (describing the historical evolution of the shareholder rights movement and the “waning” of the shareholder agency cost problem).

120. See, e.g., KENNETH BERTSCH & CHRIS MANN, MOODY’S INVESTORS SERV., CEO COMPENSATION AND CREDIT RISK 5-8 (2005) (finding that equity-based compensation is positively correlated with credit downgrades and defaults); Elizabeth Strock Bagnani et al., *Managers, Owners, and the Pricing of Risky Debt: An Empirical Analysis*, 49 J. FIN. 453, 461-64 (1994) (finding that bond yields and managerial ownership are positively correlated); K.J. Martijn Cremers et al., *Governance*

more closely aligned with shareholders pay a significant premium on bank loans over other firms.¹²¹ As I discuss *infra* in Section C of this Part, an extensive literature has arisen examining the ways in which creditors can ameliorate these agency costs, with negotiated covenants being a primary mechanism.

2. Employee Agency Costs

It may be counterintuitive to think of employees as having an agency cost problem, as the standard account of the corporation presumes that employees are themselves agents of their employer, which is thought to be the corporation itself (and the executives who make its decisions) or the outside investors who are said to “own” the corporation (although, as aforementioned, this view of shareholders as singularly “owning” the corporation has come to be largely rejected today).¹²² Consequently, most corporate law scholars, viewing corporate law narrowly through the lens of outside investor interests, typically elide over the agency conflicts that workers may face in their dealings with the corporation.

However, as Jensen and Meckling describe, under the contractarian view, employees face their own agency costs in dealing with the corporation. As Kent Greenfield has stated, these employee agency costs arise “in the sense that [employees] must depend on the actions of management even though their interests do not always coincide.”¹²³ As with creditors, employees experience agency conflicts with managers acting in their own interests but also have agency conflicts that arise from managerial fealty to shareholders, since employees obviously have interests that are quite distinct from those of shareholders. For example, employees prefer that the corporation invest in lower-risk projects, as they have a vested interest in the corporation’s long-term solvency, whereas shareholders care more

Mechanisms and Bond Prices, 20 REV. FIN. STUD. 1359, 1379-86 (2007) (finding that indicia of shareholder control (here, the existence of shareholders owning more than 5% of a firm’s common shares) are positively correlated with bond yields where takeover vulnerability is high, indicating that bond investors require a risk premium to invest in firms that are more closely aligned with shareholders); Richard A. DeFusco et al., *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617, 622-25 (1990) (finding that the announcement of new stock option grants negatively affects bond prices; Chenyang Wei, *Covenant Protection, Credit Spread Dynamics and Managerial Incentives* 20 (Nov. 29, 2005) (unpublished manuscript), http://pages.stern.nyu.edu/~cwei/JobMarket_CovenantsSpreadCEOIncentive_ChenyangWei.pdf (finding that equity-based compensation for CEOs is positively correlated with higher bond yields).

121. See Sudheer Chava et al., *Do Shareholder Rights Affect the Cost of Bank Loans?*, 22 REV. FIN. STUD. 2973, 2974 (2009) (finding that corporations with the lowest level of defenses against shareholder takeovers pay a premium of nearly 25% over firms with the highest level of such defenses).

122. See Matthew T. Bodie, *Employees and the Boundaries of the Corporation*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 85, 92-94 (Claire A. Hill & Brett H. McDonnell eds., 2012). Rock and Wachter are highly critical of this focus on the agency costs of outside investors, which they argue “leaves corporate law focused entirely on financial transactions that are cut off from the primary strategic operating transactions of the corporation.” Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Laws, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1628-30 (2001).

123. Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 299 (1998).

about maximizing their returns,¹²⁴ which is usually understood as maximizing the corporation's share price.¹²⁵

Managers can make decisions that directly harm the interests of employees, such as by lowering wages or eliminating benefits. They can also indirectly harm the interests of workers by increasing the firm's risk of insolvency, which could result in a large number of job losses. It is difficult for employees to address these agency problems, as they typically have steep informational asymmetries¹²⁶ and bear high costs in changing jobs.¹²⁷ Moreover, non-unionized employees, who have grown steadily as a share of the workforce in recent decades,¹²⁸ face large collective action and coordination problems in trying to deal with these agency costs.

There is also a sharp conflict of interest between employees and shareholders. While there is some overlap in interest, to the extent that both groups want to see the firm succeed and generate lots of wealth, there are clear tensions when it comes to allocating those returns, which can foster inefficient rent-seeking behavior. Thus, employees must be wary of corporate insiders acting on behalf of shareholders. Indeed, there is evidence that firms, acting on behalf of shareholders, deliberately take on more debt (and thus increase their risk of insolvency) with the strategic goal of improving their bargaining position vis-à-vis employees.¹²⁹

As John Coffee has described, this is exactly the phenomenon that appeared to drive the spate of LBOs in the 1980s.¹³⁰ These LBOs were motivated in large part by the great amounts of free cash flow that corporations at the time were retaining (rather than reinvesting or distributing as dividends).¹³¹ Why did corporations keep such high excess reserves during this period? Theories abound, but one factor may have been that managers at the time saw themselves as fiduciaries of all corporate stakeholders, not just of shareholders.¹³² Thus, keeping free cash flow on hand satisfied the strong preferences of employees and creditors, as this served as a

124. See Coffee, *Unstable Coalitions*, *supra* note 99, at 1499-1500 (describing how employees have a strong interest in the firm's solvency, which imbues them with a preference for retaining free cash flow or reinvesting it in low-risk projects, whereas shareholders have a preference for distributing such free cash flow in the form of dividends or reinvesting it in high-risk, high-return projects).

125. Of course, the idea that stock price reflects shareholder value maximization depends critically on Fama's efficient capital markets hypothesis, in which the stock price is seen as efficiently reflecting all publicly available (and in some formulations, all privately available) information. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 415 (1970).

126. See Coffee, *Unstable Coalitions*, *supra* note 99, at 1521-22; Greenfield, *supra* note 123, at 301-02.

127. See ALAN MANNING, MONOPSONY IN MOTION: IMPERFECT COMPETITION IN LABOR MARKETS 360 (2003) (stating that labor frictions, including mobility costs, provide employers with greater market power); Greenfield, *supra* note 123, at 302.

128. In 1983, the union membership rate among wage and salary workers was 20.1%. In 2014, the union membership rate was 11.1%. News Release, BUREAU OF LABOR STAT., Union Members—2015 (Jan. 23, 2015) [hereinafter Union Members—2015], <http://www.bls.gov/news.release/union2.nr0.htm>.

129. See David A. Matsa, *Capital Structure as a Strategic Variable: Evidence from Collective Bargaining*, 65 J. FIN. 1197, 1199-1201 (2010).

130. Coffee, *Unstable Coalitions*, *supra* note 99, at 1499-1503, 1521-28.

131. *Id.* at 1499-1503.

132. *Id.* at 1501-02.

buffer against insolvency and a form of insurance that the fixed obligations promised to these stakeholders (salaries, interest payments, etc.) would be paid in full.¹³³ But shareholders, working hand in hand with corporate managers, “unlocked” additional share value by accepting highly leveraged takeover bids, which effectively were financed by these uninvested reserves.¹³⁴ The results were catastrophic for employees, as many of these companies were unable to meet their increased debt obligations and went insolvent or fired employees to reduce costs.¹³⁵

C. Contractarianism and Shareholder Primacy

What the preceding analysis should illustrate is that corporate law’s focus on shareholder interests is not an obvious outcome under the contractarian view of the corporation currently in vogue. The idea that the corporation is essentially a web of contractual and quasi-contractual relationships between corporate stakeholders should lead one to the clear conclusion that all of the corporation’s stakeholders face potentially high agency costs. As a practical matter, the other inputs that go into the corporation, whether these are debt financing or simply hard work, are no less critical to the success of the corporation than is equity capital. So why should corporate law concern itself primarily with shareholder agency costs while ignoring the agency costs faced by other stakeholders?

Two main justifications for shareholder primacy are typically given under the contractarian account of corporate governance. First, the residual claimant status of shareholders gives them the best incentives to maximize firm value.¹³⁶ Second,

133. *Id.*

134. *Id.*

135. *Id.* One prominent example of this was the 1986 leveraged buyout of Safeway led by Kohlberg Kravis Roberts & Co. (KKR), which Susan Faludi famously described in a 1990 Pulitzer Prize-winning story. As Faludi wrote, “The Safeway LBO is often cited as one of the most successful . . . It brought shareholders a substantial premium at the outset, and since then the company has raised productivity and operating profits and produced riches for the new investors and top management.” Susan C. Faludi, *The Reckoning: Safeway LBO Yields Vast Profits but Exact a Heavy Human Toll*, WALL ST. J., May 16, 1990, <http://blogs.wsj.com/corporate-intelligence/2014/03/05/safeway-buy-out-take-a-trip-down-memory-lane>. Existing shareholders reaped huge benefits, receiving \$67.50 per share (an 82% increase over three months), as did management. *Id.* KKR also profited immensely from the deal, eventually earning the firm \$7.2 billion on an initial investment of \$129 million. See Tom Gara, *Safeway Buy-Out? Take a Trip Down Memory Lane*, WALL ST. J.: CORP. INTELLIGENCE BLOG (Mar. 5, 2014, 7:49 PM), <http://blogs.wsj.com/corporate-intelligence/2014/03/05/safeway-buy-out-take-a-trip-down-memory-lane>. But these benefits came largely at the expense of employees. Sixty-three thousand workers were laid off as a result of the LBO, typically with no notice and with a severance package of one week’s pay per year-of-service (capped at eight weeks’ pay) and two weeks of medical insurance coverage. See Faludi, *supra*. Those employees who remained saw their salaries slashed, with average pay dropping from \$12.09 per hour in 1986 to \$6.50 per hour in 1988. *Id.* Job security also became very tenuous, with employees concerned about “hardball labor policies and high-pressure quota systems.” *Id.* Safeway had long been considered a worker-friendly employer, but as Faludi notes, shortly after the LBO and the mass firings that accompanied it, Safeway retired its longtime motto “Safeway Offers Security.” *Id.*

136. Shareholders are differently situated than other stakeholders as far as the type of claim that they have on the firm’s assets. While other stakeholders are generally understood as having a “fixed claim”—that is, a claim to a fixed dollar amount, whether that is the principal and interest promised in a loan contract, or the salary promised in an employment contract—shareholders possess what is called a “residual claim”—a claim to whatever assets are left over after all other obligations have been paid.

shareholders are more poorly situated to address agency conflicts through contractual solutions or the protections of external laws than are non-shareholders.

1. Residual Claimants Have Appropriate Incentives to Maximize Firm Value

One key argument for shareholder primacy is that shareholders, as residual claimants who are paid last, are best positioned to maximize value for *all* of the corporate constituents. This claim is based on the priority structure of the corporation's payments. When a corporation invests in a particular business project, the gains from that project are put into the corporate general treasury and apportioned based on a legally and contractually defined order of priority — secured creditors typically get paid first; employees and senior unsecured creditors get paid next; junior unsecured creditors get paid after that; and finally the shareholders receive what's left—the residual claim. Thus, it is argued that shareholders have the appropriate incentives to ensure that everyone ahead of them in priority gets paid, since shareholders only receive the residual—whatever is left over. In short, shareholder interests should be prioritized over other interests because their interests are best aligned with those of all other stakeholders, and thus shareholder primacy creates the most efficient outcome.¹³⁷

2. Non-Shareholder Interests Are Better Protected by Contract or Law

Another justification often given for shareholder primacy is that non-shareholders are in a better position to protect their interests through contract, due both to the fixed nature of their claims and the types of relationships they hold with the corporation.¹³⁸ For example, it is pointed out that creditors and employees often engage in protracted negotiations before settling on a final contract, which is limited in its duration and promises a defined set of claims; these groups are thus much more capable of protecting their interests through contract than are shareholders, who have open-ended, indefinite claims that are not typically negotiated through contract.¹³⁹

In theory, of course, shareholders could also write contracts to protect their interests, but it is argued that these transaction costs—that is, the costs of writing and enforcing such contracts—would be prohibitively high.¹⁴⁰ As residual

137. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 403 (1983).

138. See, e.g., STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 69 (2008) [hereinafter *NEW CORPORATE GOVERNANCE*]; Jensen & Meckling, *supra* note 65, at 337-39. See also Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 25 (1991) [hereinafter Macey, *An Economic Analysis*] (arguing that shareholder primacy is justified because shareholders are “the group that faces the most severe set of contracting problems with respect to defining the nature and extent of the obligations owed to them by officers and directors”). Macey points specifically to poison puts for creditors and golden parachutes for employees as examples of contractual provisions that more than adequately protect the interests of non-shareholder corporate constituents. Macey, *An Economic Analysis*, *supra*, at 40.

139. See BAINBRIDGE, *NEW CORPORATE GOVERNANCE*, *supra* note 138, at 69-71.

140. *Id.* at 64.

claimants who effectively hold an open-ended contract, shareholders would need to anticipate all of the potential ways in which corporate insiders could act sub-optimally, and write contractual provisions for each of these.¹⁴¹ These contracts would invariably be incomplete, as it is impossible to anticipate every possible future contingency for a contract with an open-ended term.¹⁴² Shareholders could theoretically write contracts accounting for most of the likely contingencies, but these would be quite costly for shareholders, in a number of ways.¹⁴³ Such contracts would necessarily be extremely detailed, with a host of provisions detailing what corporate managers could and could not do.¹⁴⁴ The provisions involved would be extremely expensive to negotiate, and also to monitor and enforce.¹⁴⁵ Moreover, because such contractual terms would inevitably curtail profitable activities, they would reduce the firm's potential earnings.¹⁴⁶ Assuming that markets are relatively efficient, shareholders would factor these contracting costs into their share pricing, and as a result, these costs would be absorbed by non-shareholders.¹⁴⁷

It is further argued that shareholders face more severe problems of post-contractual opportunism than do non-shareholders.¹⁴⁸ Because non-shareholders have fixed claims, they can protect against post-contractual misbehavior by managers through relatively simple "negative control" provisions that prevent managers from engaging in certain activities, such as employee provisions against lowering wages or reducing pension benefits, or creditor provisions preventing the firm from taking on too high a level of debt.¹⁴⁹ Conversely, because shareholders seek wealth maximization, they require optimal behavior by managers and cannot rely on such negative controls to protect their interests.¹⁵⁰

A related justification for shareholder primacy is that non-shareholders are better situated to enjoy the protections of external laws. Thus, even if non-shareholders are not always able to protect their interests through contract,¹⁵¹ they

141. *Id.*

142. *Id.* In addition to the obvious agency costs involved, incomplete contracts further raise the problem of post-contractual opportunism. See generally Benjamin Klein et al., *Vertical Integration, Appropriate Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

143. Jensen & Meckling, *supra* note 67, at 323-33; see also Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 190-92 (2005).

144. Scott & Triantis, *supra* note 143, at 191-92

145. *Id.* at 192-94.

146. *Id.* at 196-98.

147. *Id.* at 196-198.

148. See Macey, *An Economic Analysis*, *supra* note 138, at 24 (stating that "the very nature of other claimants' interests makes it easier for them to protect against post-contractual opportunism by the firm"). The general idea here is that firm-specific investments can create quasi-rents, thus leading to the problem of strategic opportunistic behavior (that may not necessarily lead to an outright breach of contract) that misappropriates those rents. See also generally Klein et al., *supra* note 142. For example, a manufacturer that negotiates a contract to build specialized parts for Ford Mustangs will have to make a specific investment to manufacture these parts according to Ford's specifications, providing Ford with the opportunity to renegotiate for a lower price in the future. *Id.* at 308.

149. See Macey, *An Economic Analysis*, *supra* note 138, at 36-37.

150. *Id.* at 36.

151. There is an argument that the high transaction costs involved with contracting make this an infeasible means of protecting non-shareholder interests. Indeed, in the labor context, it is

enjoy various legal protections that limit the adverse activities of the firm and thus reduce the agency conflicts they might face in their dealings with the corporation and those who control it. Under this worldview, corporate law should reflect the interests of shareholders by establishing their interests as priorities in corporate governance, while non-corporate laws, such as environmental laws and labor laws, should protect the interests of non-shareholders by limiting the activities that the corporation can conduct.¹⁵²

Thus, according to this argument, the existence of external (non-corporate) laws that either limit the activities the corporation can take on behalf of shareholders or protect the interests of non-shareholders such as creditors or employees provides further justification for the claim that corporate law should prioritize shareholder interests. For example, Stephen Bainbridge asserts that corporate law is an “inapt tool” for protecting the interests of corporate non-shareholder constituents, as “tort, contract and property law, as well as a host of general welfare laws, already provide them with a panoply of protections.”¹⁵³ Michael Jensen, in arguing for shareholder primacy, concedes that there are a number of areas where maximizing value for shareholders may lead to a suboptimal outcome for corporate stakeholders as a whole, but argues that government regulation (and not corporate law) is the appropriate remedy to protect the interests of non-shareholders.¹⁵⁴ Jonathan Macey

important to note that the National Labor Relations Act’s creation of collective bargaining rights in 1935 was expressly based on the legislative determination that employees face high barriers to bargaining. 29 U.S.C. § 151 (1935) (“The inequality of bargaining power between employees who do not possess full freedom of association or actual liberty of contract and employers who are organized in the corporate or other forms of ownership association substantially burdens and affects the flow of commerce . . .”). This determination has been subsequently validated by a good deal of empirical and theoretical research finding that employers typically hold monopsonistic bargaining positions. Manning has a good overview of the literature and arguments. See ALAN MANNING, *supra* note 127. MONOPSONY IN MOTION: IMPERFECT COMPETITION IN LABOR MARKETS (2013). As Van Wezel Stone has described, this inequality in bargaining power is in large part due to the high degree of firm-specific investments made by workers, which causes them to incur high switching costs should they leave their employer. Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 49-53 (1991). In addition to unequal bargaining power, employees face a number of other very high transaction costs. They typically have steep informational asymmetries. See Coffee, *Unstable Coalitions*, *supra* note 99, at 1521-1522; Greenfield, *supra* note 123, at 301-02. And they suffer from collective bargaining and coordination issues that raise the costs of contracting significantly. Van Wezel Stone, *supra* at 56-69. These problems are of course even greater for non-unionized employees, who have grown steadily as a share of the workforce in recent decades. For example, in 1983, the union membership rate among wage and salary workers was 20.1%. In 2014, the union membership rate was 11.1%. Union Members—2015, *supra* note 128. Other non-shareholder groups also face high barriers to effective contracting. For example, a long-studied problem in contracts law has been the structural inequality in bargaining power between firms and consumers. See, e.g., Albert H. Choi & George G. Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665 (2012) (illustrating that bargaining power asymmetries can lead to the formation of inefficient contracts, insofar as they are not Pareto superior, even with respect to non-price terms). Consumer bargaining problems are exacerbated by the persistence of consumer mistakes in evaluating certain types of contract terms, particularly when there is a high degree of heterogeneity and complexity. See generally Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008).

152. See Robert B. Reich, *The New Meaning of Corporate Social Responsibility*, 40 CAL. MGMT. REV. 8, 15 (1998).

153. BAINBRIDGE, *NEW CORPORATE GOVERNANCE* *supra* note 138, at 72.

154. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8 (2001).

makes a similar point, in noting that contracts between the corporation and its non-shareholder constituencies are interpreted and enforced against a legal background based on the type of contracts at stake; for example, disputes between corporations and employees are resolved in the context of employment and labor law.¹⁵⁵

3. Shareholder Primacy as the “Default Rule” of Corporate Ordering

Based on the above justifications for shareholder primacy, advocates of shareholder primacy have made the normative claim that shareholder primacy should serve as the “default rule” of corporate private ordering, for two reasons.¹⁵⁶ First, it is argued that shareholder primacy minimizes agency costs, for the reasons described above. The goal of minimizing corporate agency costs is a non-trivial concern. An enormous body of research has developed looking into ways to reduce such agency costs, because they are seen as a significant drag on capital formation.¹⁵⁷ Thus, the claim that shareholder primacy most efficiently reduces agency costs provides an important rationale for the prioritization of shareholder interests.

Second, it is asserted that shareholder primacy reflects the outcome that corporate stakeholders would agree to under most circumstances, if there were no transaction costs. While the transaction costs involved with corporate activity make actual contracts untenable, the idea of a hypothetical contract without transaction costs has been instrumental for helping corporate law and economics scholars explore the boundaries and problems of agency costs, and how various features of corporate governance might help minimize those agency costs. Because shareholders are best situated to serve the interests of all corporate stakeholders, and because they are least protected by alternative mechanisms such as contract or external laws, it is argued that shareholder primacy would typically be the result of any such hypothetical bargain.

Thus, the shareholder primacy norm is described as “both normative and positive: that corporate law *should* take this form; and that it ‘almost always’

155. Macey, *An Economic Analysis* at *supra* note 138, at 39-41.

156. The term “default rule” refers to a contractual term provided by law that “govern[s] in the absence of contrary agreement”—in other words, a mutable rule that parties can contract around by express agreement. Ian Ayres, *Default Rules for Incomplete Contracts*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 585 (Peter Newman ed., 1998). Default rules are meant to fill in the gaps in an incomplete contract with the terms that most private parties would choose under most circumstances and thus serve to operate efficiently as the operative contractual term. Default rules are contrasted with “mandatory” or “immutable” rules that cannot be discarded by the voluntary agreement of contractual counterparties. *Id.*

157. See, e.g., Lucian Arye Bebchuck et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (analyzing the use of incentive-based compensation as a means for lowering agency costs); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986) (looking into how fiduciary duties might mitigate agency costs); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (exploring the managerial employment market and its informational asymmetries as a reason for lower agency costs); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327 (1983) (looking into whether incentive structures that encourage mutual monitoring by managers may reduce agency costs); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (describing how the threat of corporate takeovers can reduce agency costs).

does.”¹⁵⁸ It is normative in that it provides important policy justifications for prioritizing the interests of shareholders over other corporate stakeholders.¹⁵⁹ Corporate law should enable and facilitate private ordering, providing the default rules that work best for most corporate stakeholders, but allow stakeholders to contract around these rules if doing so is in their interest. In this way, corporate law promotes efficient capital formation. As Bainbridge has described it, “The basic thesis of the hypothetical bargaining methodology is that by providing the rule to which the parties would agree if they could bargain . . . society facilitates private ordering.”¹⁶⁰

The shareholder primacy norm is said to be descriptive insofar as it well describes the particular characteristics of corporate law.¹⁶¹ The fact that the various features of shareholder primacy are so ubiquitous and dominant in corporate law is itself used as evidentiary support of the normative arguments for shareholder primacy in corporate law. Because states are competing with one another for corporate charters, it is argued that efficient corporate law terms—those that reflect the default rules of corporate ordering—should, in theory, win out over time.¹⁶² Under this logic, the durability and ubiquity of certain terms that prioritize shareholder interests in corporate law among the fifty states is offered in support of the claim that shareholder primacy reflects the default rules of corporate ordering.¹⁶³ This view of corporate law as a “race to the top” is also buttressed by empirical evidence that shareholders require a premium to invest in the securities of corporations based in states that have less robust shareholder primacy,¹⁶⁴ although it should be noted that these results are skewed by the importance of Delaware corporate law (which emphasizes strong shareholder primacy).¹⁶⁵

158. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 783 (2006).

159. See Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 860 (1997) (reviewing PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995)) (“The nexus of contracts model has important implications for a range of corporate law topics, the most obvious of which is the debate over the proper role of mandatory legal rules.”).

160. BAINBRIDGE, NEW CORPORATE GOVERNANCE, *supra* note 138, at 35.

161. Of course, corporate law is created by state legislatures and state courts in the United States. This generates “competition” between the fifty states, which arguably facilitates the creation of efficient corporate laws, insofar as corporate investors can reward or penalize firms that are incorporated in certain states by demanding higher or lower premiums (or choosing not to invest) based on the particular legal features of the incorporating state’s corporate law system. See, e.g., William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303 (1997).

162. See Carney, *supra* note 162; Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 NW. U. L. REV. 913 (1982); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

163. See BAINBRIDGE, NEW CORPORATE GOVERNANCE, *supra* note 138, at 35–36.

164. *Id.*

165. See generally Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (noting that the majority of public corporations are incorporated in Delaware, thus giving it an outsized impact on corporate law in the United States). Of course, there are many who vehemently disagree with the view that the competition for corporate charters creates a race to the top, and instead argue that this creates a “race to the bottom.” See generally Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105

III. Corporate Political Activity and Non-Shareholder Agency Costs

Agency costs created by corporate political activity for non-shareholders have not yet been studied. In this Part, I make two arguments. First, I illustrate that corporate political activity can create agency costs for non-shareholders, reviewing some of the literature on the effect of legal changes on creditor and employee interests, and reviewing several real world examples of how CPA performed on behalf of shareholders negatively impacted non-shareholder interests. Second, I argue that these non-shareholder agency costs can be quite substantial.

A. Corporate Political Activity Can Create Agency Costs for Non-Shareholders

Corporate political activity raises new agency problems for non-shareholders, in addition to the ones that they already face in corporate governance. Unfortunately, there is a dearth of research on the agency costs of CPA for non-shareholders, as this issue has not yet been addressed in the literature. But as the previous sections describe, it is clear that there are often sharp conflicts between the interests of different corporate stakeholders. Thus, non-shareholders may face many of the same managerial agency problems as shareholders. Brudney's example of the racist and sexist CEO who uses the corporation's Treasury funds to help pass legislation allowing race- and sex-based discrimination, described *supra* in Part I.B, is not only divergent from the interests of shareholders, but also from the interests of other corporate stakeholders. But non-shareholders also face a potential divergence of interests with shareholders as well, and thus face an additional layer of agency conflicts to the extent that shareholder interests are emphasized in corporate governance, as they are today.¹⁶⁶ Using Brudney's example, if we posit a racist and sexist CEO, *backed by the full support of racist and sexist shareholders*, using corporate resources to back legislation allowing it to discriminate, this scenario would not necessarily create agency costs for assenting shareholders, but would potentially create agency costs for dissenting non-shareholders.

A number of studies demonstrating the importance of legal and regulatory changes to non-shareholder interests seem to support this point. When legislation is passed that increases the bargaining power of workers, corporations respond by reducing their leverage (and thus their risk of insolvency).¹⁶⁷ Stronger legal

HARV. L. REV. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). Indeed, those who argue the "race to the bottom" hypothesis have pointed to the proliferation of state antitakeover laws, including in Delaware, as strong empirical evidence in support of their view, since these statutes clearly do not benefit shareholders. See Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers From Takeovers*, 99 COLUM. L. REV. 1168 (1999). But see Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 855-59 (1993) (arguing that Delaware's reluctance to adopt an antitakeover statute that was considerably weaker than other states' supports the claim that competition between the states does benefit shareholders).

166. See generally Rock, *supra* note 98.

167. Elena Simintzi et al., *Labor Protection and Leverage*, 28 REV. FIN. STUD. 561, 561 (2015) (finding that legislative reforms increasing employment protection are associated with a 187 basis point reduction in leverage).

protections for labor are associated with lower bond yields, due at least in part to lower investments in risky activities, and lower rates of outside acquisition, which debt investors view as beneficial for firm solvency.¹⁶⁸ Stronger labor protections are also correlated with a higher cost of equity, suggesting that shareholders may view these as limiting their ability to maximize profits.¹⁶⁹ A similar dynamic is found with creditor rights, as legal protections enhancing creditor rights in bankruptcy or otherwise are associated with lower risk-taking by firms.¹⁷⁰ To the extent that corporate political activity can effectuate legal and regulatory changes, it creates a costly agency problem for non-shareholders.

The idea that CPA can exacerbate agency conflicts for non-shareholders is not merely a theoretical proposition. Below, I briefly describe several examples of how CPA that has benefited shareholders has harmed non-shareholder interests. These examples largely illustrate CPA as a form of risk-shifting from shareholders to other stakeholders, and indeed, much of the creditor-shareholder and employee-shareholder conflict is based in such risk-shifting, but these examples are meant to be merely illustrative.

1. Example 1: Financial Deregulation

The schism between shareholder and creditor interests in CPA is probably most starkly illustrated in the case of financial institutions. Because banks are so highly leveraged, and because their profitability is so directly tied to the amount of risk and leverage they take on, the conflict between shareholders and creditors is particularly extreme in banking. There is a well-developed literature on this subject.¹⁷¹ Financial institutions are heavily regulated, with the primary focus of this regulation being to limit the amount of risk that these firms can take on in their investments.¹⁷² Because of these strong regulatory restrictions on risk-taking, there

168. See Huafong Jason Chen et al., *Do Nonfinancial Stakeholders Affect the Pricing of Risky Debt?: Evidence From Unionized Workers*, 16 REV. FIN. 347, 347 (2012) (finding that corporations operating in more unionized industries have lower bond yields). But see Blaylock et al., *supra* note 99, at 325 (finding that, in the Chrysler bankruptcy, which affected numerous firms, those corporations in more unionized industries experienced higher bond yields following the government's intervention, illustrating the agency costs between creditors and employees in insolvent firms).

169. See generally Huafong Jason Chen et al., *Labor Unions, Operating Flexibility, and the Cost of Equity*, 46 J. FIN. & QUANTITATIVE ANALYSIS 25 (2011).

170. Viral A. Acharya et al., *Creditor Rights and Corporate Risk-Taking*, 102 J. FIN. ECON. 150, 151-52 (2011).

171. See, e.g., A. Sinan Cebenoyan et al., *Deregulation, Reregulation, Equity Ownership, and S&L Risk-Taking*, 24 FIN. MGMT. 63, 63 (1995) (finding that savings and loans with a high concentration of managerial stock ownership took on greater risk); A. Sinan Cebenoyan et al., *Ownership Structure, Charter Value, and Risk-Taking Behavior for Thrifts*, 28 FIN. MGMT. 43, 43 (1999); Gary Gorton & Richard Rosen, *Corporate Control, Portfolio Choice, and the Decline of Banking*, 50 J. FIN. 1377, 1377 (1995); Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 449 (1974) (analyzing changes in the pricing of debt based on changes in the firm's risk profile); Anthony Saunders et al., *Ownership Structure, Deregulation, and Bank Risk Taking*, 45 J. FIN. 643, 643 (1990); Smith & Warner, *supra* note 107.

172. This "safety and soundness" regulation relies heavily on capital requirements, but also emphasizes other regulatory mechanisms, particularly in the aftermath of the financial crisis and the regulatory overhaul that followed. I describe these regulations in greater detail in a previous Article. David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437, 471-72 (2013).

is a sharp opposition between the political interests of bank shareholders, whose preference is to loosen bank risk regulations so that they can increase their expected returns, and bank creditors, who want to maintain a high level of such regulation to protect bank solvency and the value of their investments.¹⁷³

For a number of reasons, financial firms have tended to be closely aligned with the political interests of shareholders.¹⁷⁴ Moreover, the financial services industry has been extremely active in trying to influence the political process. Since at least the 1960s, banks have been lobbying to loosen the New Deal-era restrictions on their business.¹⁷⁵ The financial services industry spent \$1.2 billion on corporate political activity between January 1, 2013 and November 16, 2014,¹⁷⁶ and is by far the largest single source of corporate political spending in the United States.¹⁷⁷ Between 1999 and 2008, the industry spent \$2.7 billion in reported federal lobbying expenses and contributed more than \$1 billion in campaign contributions.¹⁷⁸ While it is difficult, due to the complexity and opacity of the political process, to empirically demonstrate a causal relationship between CPA and regulatory changes, a wide array of observers have concluded that the financial

173. Of course, during bank runs and financial panics, the political interests of creditors and shareholders converge, insofar as both want increased liquidity and guarantees (collectively often described as bailouts) from the government. *See generally* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421 (2015).

174. Among the drivers of this closer alignment of shareholder and manager interests were various measures meant to improve corporate governance. Bratton and Wachter, and Rock, have good summaries of these efforts. *See supra* notes 119-120 and accompanying text. As Coffee describes, the evidence emerging from the 2008 financial crisis indicates that the high degree of incentive-based compensation did align managerial interests with shareholder interests and that the high degree of risk that banks took on prior to the financial crisis was consistent with shareholder preferences. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1051-56 (2012).

175. *See* MATTHEW SHERMAN, CTR. FOR ECON. & POL'Y RES., A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES 9 (2009). It is difficult to empirically measure how financial firms spend on CPA, because this data is largely unreported. That being said, there is significant reason to believe that these expenditures were unidirectional in pushing for deregulation and regulatory forbearance on risk-related regulation. For example, Igan and Mishra found "strong evidence" that political spending by the financial services industry was associated with the probability of a legislator changing to a deregulatory stance. Deniz Igan & Prachi Mishra, *Three's Company: Wall Street, Capitol Hill, and K Street at 20* (IMF Working Paper, 2011). Igan et al. found that CPA by financial institutions was associated with greater risk-taking from 2000-2007, and with worse outcomes in 2008. Deniz Igan et al., *A Fistful of Dollars: Lobbying and the Financial Crisis*, in 26 NBER MACROECONOMICS ANNUAL 195, 195-97 (Jonathan A. Parker & Michael Woodford eds., 2011). Simon Johnson, the former chief economist of the International Monetary Fund, has described the financial services industry's "enormous political weight" as being a primary factor behind the "river of deregulatory policies" that were implemented between the 1980s and 2000s. Simon Johnson, *The Quiet Coup: How Bankers Took Power and How They're Impeding Recovery*, THE ATLANTIC, May 2009, <http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364>.

176. *Wall Street Money in Washington*, AM. FOR FIN. REFORM 1, 4 (Dec. 11, 2014), <http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/07/WallStreetMoneyDec2014.pdf>; *see also* Dorie Apollonio et al., *Access and Lobbying: Looking Beyond the Corruption Paradigm*, 36 HASTINGS CONST. L.Q. 13, 50 tbl.3 (2008) (noting that the financial services sector was the largest source of lobbying expenditures in 2006, spending \$259 million).

177. *See 2014 Overview: Totals by Sector*, CTR. FOR RESPONSIVE POL., <https://www.opensecrets.org/overview/sectors.php>.

178. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xvii (2011).

services industry's outsized efforts to influence lawmakers and regulators were a main driver in the extensive deregulation and regulatory forbearance of the financial services industry observed during the 1990s and 2000s.¹⁷⁹

Beginning in 1980, Congress responded with a series of increasingly sweeping changes to banking regulation. These included: the Depository Institutions Deregulation and Monetary Control Act of 1980, which loosened portfolio restrictions on thrift institutions and preempted state usury laws;¹⁸⁰ the Garn-St Germain Depository Institutions Act of 1982, which essentially eliminated portfolio restrictions on thrift institutions and removed interest rate caps on deposits;¹⁸¹ the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which removed geographic and branching restrictions on banks;¹⁸² the Gramm-Leach-Bliley Act of 1999, which eliminated Glass-Steagall prohibitions on bank ownership or affiliation with securities and insurance companies;¹⁸³ and the Commodity Futures Modernization Act of 2000 (CFMA), which exempted a broad class of over-the-counter derivatives from most forms of regulatory oversight.¹⁸⁴

Federal banking regulators also responded to political lobbying. In some cases they looked the other way, as with their refusal to block the Citigroup-Travelers merger in 1998¹⁸⁵ or their failure to issue predatory lending standards during the subprime mortgage boom.¹⁸⁶ In other cases, they affirmatively wrote rules and regulations that allowed banks to take on greater risk. For example, the Federal Reserve's 1996 guidance allowed bank holding companies to diversify into investment banking activities.¹⁸⁷ In 1998, bank regulators failed to block the proposed merger of Citigroup with Travelers Insurance.¹⁸⁸ In 2004, the Securities and Exchange Commission created the "Consolidated Supervised Entity" program,

179. For example, Simon Johnson has described the financial services industry's "enormous political weight" as being so influential as to have "effectively captured" the U.S. federal government. Johnson, *supra* note 176.

180. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.); *see also* Min, *supra* note 173, at 452-53.

181. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.); *see also* Min, *supra* note 173, at 452-53.

182. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C.); *see also* Mark D. Rollinger, *Interstate Banking and Branching Under the Riegle-Neal Act of 1994*, 33 HARV. J. ON LEGIS. 183 (1996).

183. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C.). For a detailed account of some of the changes created by Gramm-Leach-Bliley, *see* Edward J. Janger & Paul M. Schwartz, *The Gramm-Leach-Bliley Act, Information Privacy, and the Limits of Default Rules*, 86 MINN. L. REV. 1219, 1222-32 (2002).

184. Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified as amended in scattered sections of 7, 11, 12, and 15 U.S.C.).

185. *See* Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 75 (2013) (describing how federal regulators gave positive signals to Citigroup and Travelers to merge, thereby putting pressure on Congress to change the law so as to make the merger retroactively legal).

186. *See generally* Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1344-47 (2009).

187. *See* SHERMAN, *supra* note 176, at 9.

188. *Id.* at 9-10.

which provided optional prudential regulatory oversight for the holding companies of broker-dealers facing more stringent prudential oversight in Europe unless they had U.S. oversight.¹⁸⁹ The Office of the Comptroller of the Currency's 2005 rule preempted state anti-predatory lending laws.¹⁹⁰

Banking deregulation was widely blamed for causing the savings and loan crisis of the late 1980s and early 1990s.¹⁹¹ Nearly two decades later, banking deregulation was blamed for the massive financial crisis we experienced in 2008. As the Financial Crisis Inquiry Commission, the body authorized by Congress to investigate the causes of the financial crisis, stated:

We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe.¹⁹²

Of course, the very high levels of risk that banking deregulation allowed ultimately resulted in large losses for shareholders and creditors alike.¹⁹³ But from an *ex ante* perspective, the decision to take on greater risk was one that benefited bank shareholders, as I described in Part II.B.1.¹⁹⁴ Shareholders themselves certainly seemed to believe that higher bank risk was valuable. As Bratton and Wachter describe, the stock prices of banks that took on higher leverage during the pre-crisis period "handsomely outperformed the market as a whole,"¹⁹⁵ while banks that took on more conservative strategies saw their stock prices lag significantly behind.¹⁹⁶ In other words, shareholders applauded the CPA that led to the deregulation of risk constraints on banks and other financial institutions, and the greater risk this allowed. Conversely, creditors lost enormous sums of money, even with the massive bailouts provided by the federal government.¹⁹⁷

189. See Office of Inspector Gen., *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, U.S. SEC. & EXCH. COMM'N, (Sept. 2008), <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>.

190. See McCoy et al., *supra* note 187, at 1348-51.

191. See Min, *supra* note 173, at 452-54.

192. FIN. CRISIS INQUIRY COMM'N, *supra* note 179, at xviii.

193. Of course, many creditor losses were effectively transferred to taxpayers as a result of a wave of government bailouts. One could argue that the CPA done on behalf of banks to deregulate the industry was not contrary to the interests of creditors, given creditor expectations that they might be rescued. But as I have pointed out, the argument that creditors expected to be bailed out ignores the significant uncertainty about whether and to what extent a particular class of creditors might be insulated against loss. See Min, *Understanding the Failures of Market Discipline*, *supra* note 173, at 1473-74. Moreover, this claim is not supported by the pricing and liquidity changes we observed prior to and during the financial crisis. In fact, SIFI liabilities experienced a high degree of price volatility, indicating that creditors were quite concerned about credit losses. *Id.*

194. See *supra* notes 107-112 and accompanying text.

195. Bratton & Wachter, *supra* note 119, at 717.

196. *Id.* at 720-21.

197. It is difficult to estimate exactly how large creditors' losses from the 2008 crisis might have been, as government bailouts by the United States, the Bank of England, the European Central Bank, and various European national governments effectively transferred many of these losses from bank creditors to taxpayers. One measure that might be used is the size of government bailouts, which in the United States totaled \$3 trillion at its peak, and perhaps much more than that, if we

2. Example 2: Enron

The spectacular failure of Enron is generally told as a story of accounting fraud and shareholder agency problems: opportunistic managers and directors, seeking to maximize their incentive-based compensation, utilized complex and fraudulent accounting methods (alongside complicit auditors) to conceal massive and growing losses that ultimately cost the U.S. economy an estimated \$64 billion in 2002.¹⁹⁸ But underneath that story lies another important narrative of non-shareholder agency costs, particularly as they relate to CPA. Enron was so successful—and importantly, returned enormous value to its shareholders—for most of its history because it was extremely effective in using its general treasury funds to convince politicians and regulators to change the laws in ways that were beneficial to its shareholders but not for its other stakeholders. The successful CPA employed by Enron radically altered the regulatory landscape for energy companies and allowed Enron to expand rapidly and take on enormous amounts of risk. This marked a stark change from the staid, boring, and highly regulated activities in which energy companies could engage before Enron came on the scene.

Enron was deeply involved in political activity almost since its first days. Enron's extensive CPA began in the early 1990s. It was one of the major lobbyists behind the successful push to pass the Energy Policy Act of 1992,¹⁹⁹ which created a new category of power plants that were exempt from the Public Utility Holding Company Act's provisions restricting energy companies from geographic expansion and affiliations.²⁰⁰ The passage of the Energy Policy Act was critical to Enron's early success, as it allowed the company to utilize the holding company structure to expand quickly, both in terms of its geographic presence and its lines of business. Within two years, Enron was the largest buyer and seller of natural gas in North America and the leader in electrical power trading.²⁰¹ Enron continued to lobby aggressively for increased deregulation, and established itself as one of the most aggressive and influential corporate political spenders in America. Between 1997 and 2000, Enron and its employees spent \$10.2 million in federal political expenditures.²⁰² This included contributions of \$736,800 to President George W.

consider the capacity of the various lender-of-last resort facilities utilized by the Fed. *See* Mark Adelson, *The Deeper Causes of the Financial Crisis: Mortgages Alone Cannot Explain It*, 39 J. PORTFOLIO MGMT. 16, 19-20 (2013). Another way to measure losses is to look at total write-downs made by the financial sector, which was estimated to be some \$3.6 trillion. *Id.* at 18. In 2009, the credit rating agency Moody's looked at the bonds it had rated, and determined that there were approximately \$281 billion in defaults on those bonds, with nearly 80% of those defaults coming from the banking and finance sectors. MOODY'S INVESTORS SERV., CORPORATE DEFAULT AND RECOVERY RATES, 1920-2009, at 5 (2009), <https://www.moody's.com/sites/products/DefaultResearch/2007400000578875.pdf>.

198. *See, e.g.,* Beth Arnold & Paul de Lange, *Enron: An Examination of Agency Problems*, 15 CRITICAL PERSP. ON ACCT. 751 (2004).

199. Energy Policy Act of 1992, Pub. L. 102-486, 106 Stat. 2776, 2795 (1992) (codified as amended at 42 U.S.C. § 13201).

200. Hon. Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35, 85 (2005).

201. *Id.* at 85-86.

202. Pratap Chatterjee, *Enron: Pulling the Plug on the Global Power Broker*, CORPWATCH (Dec. 13, 2001), <http://www.corpwatch.org/article.php?id=1016>.

Bush,²⁰³ as well as contributions to the campaigns of seventy-one U.S. Senators and 188 members of the House of Representatives.²⁰⁴ Enron also spent heavily on federal lobbying. While it is unclear exactly how much it spent on this effort, in 2001 it spent over \$3 million on registered federal lobbyists alone, a figure that almost certainly represents the tip of a very large iceberg.²⁰⁵

Enron was also a huge political player at the state level, lobbying politicians and regulators in at least twenty-eight states from 1997 to 2000.²⁰⁶ This included more than \$1.9 million in campaign contributions to over 700 candidates for state office and a far greater sum on lobbying expenses.²⁰⁷ For example, Enron spent more than \$345,000 on lobbying expenses in California and as much as \$945,000 on lobbying expenses in Texas, in a successful effort to convince those two states to deregulate their energy markets.²⁰⁸ Ultimately, Enron was successful in convincing twenty-four states to adopt some form of energy deregulation.²⁰⁹ While it is usually difficult to attribute a causal relationship between political lobbying and legislative changes, because of the aggressiveness of Enron's lobbying, the deregulation that occurred at the state level was widely attributed to Enron, and Enron alone.²¹⁰ As one prominent expert observed, "Enron was the only company out there lobbying and they were everywhere They not only carried a lot of water for themselves. But they carried water for the rest of the industry."²¹¹

Finally, Enron played a critical role in shaping and passing CFMA, which laid out guidelines for the regulation of over-the-counter (OTC) derivatives.²¹² CFMA was drafted following the massive and sudden failure of the hedge fund Long-Term Capital Management (LTCM), which had relied heavily on OTC derivatives to carry out its investment strategy. Because of the opacity of OTC derivatives, regulators and investors were not aware of the extent to which LTCM was

203. MINORITY STAFF OF H. COMM. ON GOV'T REFORM, 107TH CONG., BUSH ADMINISTRATION CONTACTS WITH ENRON 1 (Comm. Print 2002).

204. See STEVE ISSER, *ELECTRICITY RESTRUCTURING IN THE UNITED STATES: MARKETS AND POLICY FROM THE 1978 ENERGY ACT TO THE PRESENT 194-95* (2015).

205. MINORITY STAFF OF H. COMM. ON GOV'T REFORM, *supra* note 204, at 2. As this staff report notes, the methodology they used "is likely to underestimate significantly" the total amount of federal lobbying expenditures made by Enron. *Id.* Moreover, lobbying disclosures underestimate the many ways in which lobbying expenditures actually occur, as "public relations" and "media relations" expenditures often serve the same purposes as lobbying, but are not disclosed as such. For example, the American Petroleum Institute disclosed slightly more than \$7 million in lobbying expenditures in 2012, but it spent far more than this on other activities meant to further their advocacy goals, including payments of \$85.5 million to four public relations and advertising firms. See Erin Quimm, *The Misinformation Industry*, CTR. FOR PUBLIC INTEGRITY, Jan. 15, 2015, <https://www.publicintegrity.org/2015/01/15/16596/who-needs-lobbyists-see-what-big-business-spends-win-american-minds>.

206. See Leslie Wayne, *Enron's Many Strands: The Politics; Enron, Preaching Deregulation, Worked the Statehouse Circuit*, N.Y. TIMES, Feb. 9, 2002, <http://www.nytimes.com/2002/02/09/business/enron-s-many-strands-politics-enron-preaching-deregulation-worked-statehouse.html>.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. Commodity Futures Modernization Act of 2000, 7 U.S.C. § 1 (2012).

leveraged or posed systemic risk. In response to LTCM's failure, many policymakers sought to regulate OTC derivatives to ensure more disclosure and transparency.²¹³ Enron was a big player in all sorts of OTC derivatives, which allowed them to speculate on electricity prices, the influence of the weather, or whether a particular company or investment pool would remain solvent.²¹⁴ Enron sought to head off stricter regulation of its derivatives trading activities by heavily lobbying Congress, and especially Senator Phil Gramm, who represented Enron's home state of Texas and sat as chair of the Senate Committee on Banking, Housing, and Urban Affairs.²¹⁵ Enron sought to pass a bill that would not contain the more stringent oversight requirements being proposed and would exempt most of Enron's derivatives trading from regulation.²¹⁶

This bill ultimately became CFMA, and was tailored to the interests of Enron's executives. Indeed, at one point, Enron appears to have successfully convinced Senator Gramm to back off of some of his own legislative priorities to help ensure that CFMA would be enacted before the end of the legislative calendar year.²¹⁷ The bill did get passed out of Congress and signed before the end of the year, and it exempted broad swaths of derivatives trading from oversight, including two classes of transactions that were an important part of Enron's business—bilateral derivatives trades that are executed over the counter, not on a trading facility, and trades made on an electronic trading facility involving exempt commodities, a category that included most energy derivatives.²¹⁸ This exemption became known as the "Enron Loophole" due to Enron's clear influence in getting it passed into law, and because Enron was the most obvious beneficiary of this exemption at the time.²¹⁹

As with the Energy Policy Act, the passage of CFMA was critical to Enron's growth and revenues, at least for the next year. CFMA allowed Enron to continue to trade aggressively in OTC derivatives. These derivatives were central to Enron's growth and revenues.²²⁰ In 2000 alone, Enron's exposure to OTC derivatives increased five-fold.²²¹ That year, Enron reported gains of \$7.2 billion on its derivatives trading, which appears to have been the result of very high leverage.²²² Shareholders appear to have valued Enron's political activities and the increased risk that CFMA allowed Enron to take on. As Enron was actively lobbying Senator

213. Michael Schroeder & Greg Ip, *Enron Lobbied Hard to Limit Oversight of Trading Operations*, WALL ST. J., Dec. 13, 2001.

214. *Id.*

215. *Id.*

216. *Id.*

217. See Eric Lipton, *Gramm and the 'Enron Loophole'*, N.Y. TIMES, Nov. 17, 2008, <http://www.nytimes.com/2008/11/17/business/17grammside.html>.

218. See MARK JICKLING, CONG. RESEARCH SERV., RS22912, THE ENRON LOOPHOLE 1 (2008).

219. *Id.*; see also Lipton, *supra* note 218.

220. See generally Frank Partnoy, *Enron and the Derivatives World*, in ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER 169 (Nancy B. Rapoport et al. eds., 2009) (stating that Enron was "at its core" a derivatives trading firm, and that by the 2000s, its OTC derivatives trading activities dwarfed its other business activities).

221. *Id.* at 170.

222. *Id.* at 184.

Gramm to help ensure passage of CFMA in the summer of 2000, Enron's stock soared, rising from a low of \$42.50 earlier that year to its all-time high of \$90.00 per share in August 2000.²²³ President Bill Clinton signed the Commodity Futures Modernization Act into law in late December 2000; Enron stock closed out the year with a stock price of \$83.13 per share.²²⁴

As we all learned less than a year later, Enron's derivatives activities were central to its fraudulent efforts to hide its growing losses.²²⁵ But to focus only on the fraud is to miss the real story of Enron's failures. Enron was heavily leveraged and exposed to high levels of risk from both its derivatives speculation and its core energy business activities.²²⁶ As Bill Bratton describes, a "conventional market reversal" that caused losses in Enron's core energy business was a key factor in Enron's demise, and this was exacerbated by Enron's speculative derivatives activities.²²⁷ The extraordinarily high degree of leverage was largely responsible for the suddenness of Enron's downfall, as Enron experienced something akin to a bank run.²²⁸ Enron's accounting fraud was part of this story, certainly, insofar as it pumped up Enron's earnings and created an enormous credibility problem among investors that hastened Enron's collapse.²²⁹ But the accounting fraud alone appears insufficient to have caused the massive insolvency that occurred.²³⁰

Importantly, focusing on Enron's accounting fraud leads observers to the wrong conclusion about Enron's agency problems. Enron is often held up as an example of shareholder agency costs, because managers misled shareholders through a massive accounting fraud. An *Economist* editorial from 2002 captures the basic lesson that most leaders and policy experts seem to have taken away from Enron:

The Enron fiasco has shown that all is not well with the governance of many big American companies. Over the years all sorts of checks and balances have been created to insure that company bosses, who supposedly act as agents for shareholders, their principals, actually do so It is time for another effort to realign the system to function more in shareholders' interests.²³¹

223. *Enron Historical Stock Price*, UNIV. MISSOURI-KANSAS CITY SCH. OF LAW, <http://law2.umkc.edu/faculty/projects/ftrials/enron/enronstockchart.pdf>.

224. *Id.*

225. Partnoy, *supra* note 221, at 173-81.

226. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1299-1332 (2002) [hereinafter Bratton, *Enron*].

227. *Id.* at 1299-1305.

228. *Id.* at 1320-25.

229. *Id.* at 1305-20.

230. *Id.* at 1319-20, 1326-32 (stating that the size of the accounting fraud, as reflected in Enron's restated earnings, was "not large enough to bring down Enron, taken alone," and pointing out that all of the described factors, including the high leverage, the market downturn in energy production and delivery, Enron's high exposure to derivatives speculation, and its accounting fraud, were key parts of Enron's failure).

231. *The Lessons From Enron: After the Energy Firm's Collapse, the Entire Auditing Regime Needs Radical Change*, ECONOMIST, Feb. 7, 2002, <http://www.economist.com/node/976011>; see also Beth Arnold & Paul de Lange, *Enron: An Examination of Agency Problems*, 15 CRIT. PERSP. ON ACCT. 751, 763-64 (2004) (providing an example of how academics also understood the key lesson from Enron's collapse to be the need for corporate governance reform to address shareholder agency costs).

This prevailing wisdom on the lessons of Enron misses the key point that, up until August 2001, the outsized risk and massive leverage taken on by Enron was beneficial to shareholders. Had Enron's basic business continued to perform well, or had its derivatives activities generated higher revenues in 2001, Enron might have continued to generate high returns for its shareholders, just as it had done for the previous decade. It was the confluence of Enron's business problems, bad speculative bets, and high leverage that brought the accounting fraud to the forefront. But the high risk and high leverage that actually caused Enron's losses were in line with shareholder interests and in opposition to non-shareholder interests.²³²

From an ex ante perspective, it is clear that shareholders approved of Enron's extensive CPA, which unlocked markets for Enron, opened the door to acquisitions and growth, and allowed the company to take on higher amounts of leverage and risk than would otherwise be possible. Enron shareholders made money hand over fist, until August 2001. Moreover, it was also clear that Enron's corporate culture was one that could be accurately described as obsessed with shareholder value maximization, as illustrated by a famous story about Enron's CEO, Jeffrey Skilling, when he was a Harvard Business School student:

Skilling was asked what he would do if his company were producing a product that might cause harm—or even death—to the customers that used it . . . Skilling replied, “I’d keep making and selling the product. My job as a businessman is to be a profit center and to maximize return to the shareholders. It’s the government’s job to step in if a product is dangerous.”²³³

Indeed, it seems clear that Enron's extensive measures to disguise its true financial condition were intended more to preserve the company's AAA credit rating, which was critical to the massive leverage that Enron utilized, than to pump up the stock price.²³⁴ As Enron increasingly grew to look like a financial intermediary, with its revenues coming primarily from derivatives speculation and investment activities, its creditworthiness became critical to its activities. As Bratton notes, “To lose the [investment grade credit rating] is to lose the derivatives business, as counterparties take their business risks to a shop able to enter into derivatives contracts entailing no significant default risk.”²³⁵ In this light, it appears that Enron's fraud was undertaken to *benefit* shareholders, by allowing the company to double down on maintaining its share price through duping unwitting creditors.

232. *Id.* As a *Businessweek* postmortem article noted: “The seeds of [Enron’s] destruction were planted well before the [discovery of Enron’s accounting problems]. According to former insiders and other sources close to Enron, it was already on shaky financial ground from a slew of bad investments, including overseas projects ranging from a water business in England to a power distributor in Brazil. ‘You make enough billion-dollar mistakes, and they add up,’ says one source close to Enron’s top executives.” Wendy Zellner & Stephanie Anderson Forest, *The Fall of Enron*, BUSINESSWEEK, Dec. 16, 2001, <http://www.bloomberg.com/bw/stories/2001-12-16/the-fall-of-enron>.

233. PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON: EVERYONE’S GUIDE TO THE LARGEST BANKRUPTCY IN U.S. HISTORY 28 (2002).

234. See Bratton, *Enron*, *supra* note 227, at 1320-25.

235. *Id.* at 1324.

Non-shareholders, especially employees and creditors, suffered most from Enron's overreach. In the immediate aftermath of Enron's financial woes, and just ahead of its Chapter 11 bankruptcy filing, the price on Enron's bonds, formerly investment grade, dropped to a low of \$0.16 on the dollar, while the price of its bank loans dropped to a low of \$0.18 on the dollar.²³⁶ Enron's unsecured creditors ultimately received about 53% of their par value, reflecting a loss of tens of billions of dollars.²³⁷ Enron employees also suffered tremendously, with 5,000 workers losing their jobs and most of their pension and retirement benefits.

Enron's significant investments in CPA demonstrate some of the serious agency conflicts between shareholders and non-shareholders. Enron's political activities reflected exactly what shareholders should theoretically want—they changed the regulatory landscape in which Enron operated to allow the company to take on much more risk than they otherwise would have been allowed. This improved the net expected returns of shareholders, and for nearly a decade, returned enormous actual share value as well. At the same time, this CPA and the heightened risk of insolvency that it created was detrimental to the interests of employees and creditors, both *ex post* but also *ex ante*.

3. Example 3: The Leveraged Buyout of TXU

The 2007 leveraged buyout of TXU, another Texas energy company, provides an additional stark example of how CPA performed on behalf of shareholders can harm other corporate stakeholders, including creditors and employees. The \$45 billion acquisition of TXU, led by the private equity funds Kohlberg Kravis Roberts (KKR) and TPG (formerly the Texas Pacific Group), as well as the investment bank Goldman Sachs, was the largest LBO in history at the time.²³⁸ This deal, like all LBOs, was heavily funded by debt. The deal financing saddled the new company, called Energy Future Holdings (EFH), with over \$38 billion in long-term debt.²³⁹

The terms of the deal were quite favorable for shareholders, with the proposed acquisition price representing a 15% premium over the outstanding market value of TXU shares.²⁴⁰ But these terms were also very unfavorable for other stakeholders,

236. See Gregory Zuckerman, *Enron Bonds Climb as 'Vultures' Detect Value Among the Ruins*, WALL ST. J., Dec. 6, 2001.

237. See Linda Sandler, *Enron Creditors Get 53 Percent Payout, Aided by Lawsuit Accords*, BLOOMBERG BUSINESSWEEK, Jan. 13, 2012, <http://www.bloomberg.com/news/articles/2012-01-13/enron-creditors-pocket-21-8-billion-in-cash-stock-1->.

238. See *Record Buyout for TXU*, CNN, Feb. 26, 2007, <http://money.cnn.com/2007/02/26/news/companies/txu/?postversion=2007022608>; *TXU Corp. Announces Completion of Acquisition By Investors Led By KKR and TPG*, KKR MEDIA CTR., Oct. 10, 2007, http://media.kkr.com/media/media_releasedetail.cfm?ReleaseID=332996; Mitchell Schnurman, *Why TXU Corp. Was a Bad Bet*, D CEO, Oct. 2012, <http://www.dmagazine.com/publications/d-ceo/2012/october/why-txu-corp-was-a-bad-bet>.

239. See Elizabeth Souder, *Energy Future Holdings Owners Stuck With Company Worth Less Than They Paid 5 Years Ago*, DALLAS MORNING NEWS, May 26, 2012, <http://www.dallasnews.com/business/energy/20120526-energy-future-holdings-owners-stuck-with-company-worth-less-than-they-paid-5-years-ago.ece>.

240. See Jessica Hall, *Private Equity Buys TXU in Record Deal*, REUTERS, Feb. 26, 2007, <http://www.reuters.com/article/us-txucorp-takeover-kkr-idUSWNAS203120070226>.

most notably existing creditors. The high degree of leverage involved in this acquisition caused existing TXU debt investors to experience a significant and immediate decline in the value of their investments. Upon the announcement of this acquisition, the cost of purchasing credit default swaps protecting against credit losses on TXU bonds doubled.²⁴¹ A wide variety of TXU debt offerings saw their risk premiums soar correspondingly.²⁴² Shortly after the announcement of this deal in late February 2007, Fitch downgraded TXU senior unsecured debt from BBB-minus (its lowest investment grade rating) by one notch to BB-plus.²⁴³ Moody's and S&P, the other major credit rating agencies, stated at that time that they were considering downgrading TXU debt due to the proposed LBO;²⁴⁴ both firms did indeed downgrade the credit ratings on the debt issued by TXU and its subsidiaries and affiliates later that year.²⁴⁵ By May 2007, TXU investment-grade bonds due in 2024 were trading at only \$0.87 on the dollar.²⁴⁶

These harms to creditors were hardly unforeseeable. Indeed, only two years earlier, KKR had led a group of investors proposing a leveraged buyout of Unisource Energy, the holding company that owned Tucson Electric, an energy utility in Arizona.²⁴⁷ Arizona regulators rejected this deal based on concerns about the high levels of debt, the opacity of the deal's financing structure, and concerns that the deal would harm consumers for the benefit of shareholders.²⁴⁸ A few months later, Oregon's Public Utility Commission unanimously denied approval for a proposed acquisition of Portland General Electric (PGE) in another highly debt-financed deal led by TPG.²⁴⁹ Among other things, the Oregon regulator found that the high amount of debt being used to finance this takeover would lead to "lower credit ratings for PGE, undue pressure on PGE to make dividend payments to [its shareholders], and the risk of bankruptcy"²⁵⁰

²⁴¹ See *TXU's Cost of Bond Protection Doubles on Buyout Announcement*, MARKETWATCH, Feb. 26, 2007, <http://www.marketwatch.com/story/txus-cost-of-bond-protection-doubles-on-buyout-announcement>.

²⁴² *Id.*

²⁴³ See *Fitch Cuts TXU On Buyout, Moody's, S&P May Cut*, REUTERS, Feb. 26, 2007, <http://www.reuters.com/article/txu-ratings-moodys-idUSL267257220070226>.

²⁴⁴ *Id.*

²⁴⁵ See *Moody's Downgrades Existing Ratings of TXU Corp. and Subsidiaries*, MOODY'S INVESTORS SERVICE, Oct. 9, 2007, https://www.moodys.com/research/Moodys-downgrades-existing-ratings-of-TXU-Corp-and-subsidiaries--PR_142000; *S&P: TXU Downgraded to 'BB' on Acquisition Capital Plan; Still on Watch Neg.*, BONDSONLINE, Mar. 2, 2007, http://www.bondsonline.com/News_Releases/TXU_Downgraded_To_BB_Credit_Watch_Negative__2.php.

²⁴⁶ Rachel Beck, *Buyout Boom a Bust for Bondholders*, ALASKA JOURNAL OF COMMERCE, May 2007, <http://www.alaskajournal.com/community/2007-05-20/buyout-boom-bust-bondholders#.VvMr8TG2W24>.

²⁴⁷ See Reorganization of Unisource Energy Corp. No. E-04230A-03-0933 (Ariz. Corp. Comm'n Nov. 8, 2004) (order denying application for approval of merger agreement), *available at* <http://www.azcc.gov/divisions/utilities/electric/uns-0933.pdf>.

²⁴⁸ See Press Release, Ariz. Corp. Comm'n, Commission Rejects Unisource Acquisition (Dec. 23, 2004), <http://www.azcc.gov/divisions/utilities/news/pr12-23-04.htm>.

²⁴⁹ See News Release, Or. Pub. Util. Comm'n, Commission Rejects PGE Sale (Mar. 10, 2005), http://www.puc.state.or.us/Pages/news/2005/2005_007.aspx.

²⁵⁰ Order No. 05-114 at 21, Or. Elec. Util. Co. Application for Authorization to Acquire Portland Gen. Elec. Co., No. UM 1121 (Or. P.U.C. Mar. 10, 2005) (order denying application), *available at* <http://apps.puc.state.or.us/orders/2005ords/05-114.pdf>.

As a result of these previous legislative defeats in other states, the parties involved in the TXU acquisition were sensitive to how regulators might react to the deal.²⁵¹ In an apparent attempt to assuage concerns from Texas's Public Utility Commission (PUC), KKR announced that, upon the approval of the acquisition, the newly acquired TXU would commit to a 10% decrease in electricity prices through September 2008 and reduce the number of coal plants it was planning to open from eleven to three.²⁵²

KKR and TPG's fears of political action derailing their acquisition were renewed several weeks later when the Texas PUC issued its formal findings that TXU had manipulated electricity prices in 2005 and recommended \$210 million in fines against the company.²⁵³ As one media outlet observed, this "unexpectedly tough recommendation is a sign of rising regulatory interest in the proposed . . . takeover of TXU by [KKR] and TPG . . .".²⁵⁴ This heightened interest in the TXU deal was not confined to state lawmakers. Representative Joe Barton, then the ranking Republican on the House Energy and Commerce Committee, made comments that were critical of the proposed acquisition of TXU, and pondered publicly whether Texas electricity generation and delivery should be subject to federal oversight in the wake of this deal.²⁵⁵

TXU was already engaged in political activity prior to its acquisition,²⁵⁶ but it ramped up these efforts significantly in order to ensure that the merger went through.²⁵⁷ As the watchdog group Texans for Public Justice has documented, TXU

²⁵¹ See Ken MacFadyen, *An Uphill Battle to Bag the Biggest LBO Ever: Political Uncertainty and Competing Bidders Stand in the Way of KKR and TPG Clinching Their Record-Breaking LBO*, MERGERS & ACQUISITIONS, Apr. 2, 2007, <http://www.themiddlemarket.com/maj/20070401/32132-1.html>.

²⁵² *TXU to Set New Direction as Private Company: Public Benefits Include Price Cuts, Price Protection, Investments in Alternative Energy and Stronger Environmental Policies*, KKR MEDIA CTR., Feb. 26, 2007, http://media.kkr.com/media/media_releasedetail.cfm?ReleaseID=333037.

²⁵³ See *Utility TXU Slapped With \$210 Million Fine*, NBC NEWS, Mar. 29, 2007, http://www.nbcnews.com/id/17851991/ns/business-oil_and_energy/t/utility-txu-slapped-million-fine/#.VwqQF3C5Awc.

²⁵⁴ Alex Barker, *Lone Star Up 36% on Deal News*, FIN. TIMES, Mar. 30, 2007, <http://www.ft.com/intl/cms/s/0/5f3f3b2c-de5c-11db-afa7-000b5df10621.html#axzz45L10XW5y>.

²⁵⁵ See Chris Baltimore, *Texas Lawmaker Scrutinizes Proposed TXU Buyout*, REUTERS, Mar. 12, 2007, <http://www.reuters.com/article/txu-buyout-congress-idUSN1236910620070312>. KKR and TPG engaged in a significant amount of political action at the federal level to coopt potential federal jurisdiction over state energy markets. For example, immediately after Rep. Barton's comments were released, KKR and TPG hired "almost a dozen" lobbyists and retained the services of Covington & Burling LLP to help influence Congress. See Kevin Bogardus, *Lobbyists Hired to Represent Investor Groups in \$45B Buyout*, THE HILL, Mar. 27, 2007, <http://thehill.com/business-a-lobbying/3032-lobbyists-hired-to-represent-investor-groups-in-45b-buyout>.

²⁵⁶ For example, just prior to the announcement of its acquisition by KKR and TPG, TXU spent millions of dollars in lobbying and advertising in an effort to get approval from Texas regulators to open up eleven new coal plants. See R.G. Ratcliffe & Mark Babineck, *TXU Fights for 11 New Coal Plants at \$10 Billion Tab*, HOUSTON CHRON., Feb. 11, 2007, <http://www.chron.com/business/energy/article/TXU-fights-for-11-new-coal-plants-at-10-billion-1546554.php>. This included the purchase of 2400 breakfast tacos that awaited Texas legislators and their staff on the opening day of the new legislative session, accompanied by the note, "Compliments of your friends at TXU." *Id.* TXU's lobbying team during this period consisted of 27 executives, and also relied on 14 outside lobbyists. *Id.*

²⁵⁷ KKR and TPG also became heavily involved in political activity to try to assure regulatory approval of their proposed LBO. I do not describe the activities of KKR and TPG since it does not raise the same problem of non-shareholder agency costs that TXU expenditures do.

spent at least \$15 million in lobbying and related efforts in early 2007 to try to ensure that the proposed LBO would not be held up by state regulators.²⁵⁸ The target of its efforts was a bill before the Texas state legislature that would give the Texas PUC the power to review the TXU buyout and potentially force TXU's buyers to sell off the energy generation and transmission companies owned by the TXU holding company (TXU was the retail electricity provider).²⁵⁹ To stymie the bill, TXU employed a group of 65 registered lobbyists, which included a number of lobbyists who were close to Texas Lieutenant Governor David Dewhurst²⁶⁰ and Speaker of the House Tom Craddick.²⁶¹ These included Dewhurst's former business advisor and close friend Dennis Thomas, who was hired as a contract lobbyist, and Dewhurst's former chief of staff Bruce Gibson, who was hired in early 2007 as a policy advisor.²⁶² TXU also retained the services of former Dallas Mayor Ron Kirk and the son of Speaker Craddick's next-door neighbor.²⁶³

The deal ultimately turned into a disaster, both for the newly added investors (shareholders and creditors) and for existing creditors. At the time the LBO was proposed, Texas electricity prices were quite high, averaging \$56.35 per megawatt hour in 2007 and surging to \$77.19 in 2008.²⁶⁴ Texas electricity prices were closely tied to the price of natural gas, which were historically quite high at the time of the acquisition. Due in large part to technological innovations in hydraulic fracturing, or fracking, and a surge in new drilling and exploration efforts in the United States, natural gas prices plummeted from a high of \$13 per million British thermal units to a low of \$2.32 in 2012.²⁶⁵ EFH, the successor company to TXU, famously filed for bankruptcy in April 2014.²⁶⁶

²⁵⁸ See *Leveraging a Buyout: TXU's Takeover Lobby Cost About \$17 Million*, LOBBY WATCH, Aug. 14, 2007, http://info.tpj.org/Lobby_Watch/08-14-07_txuactivities07.html (documenting that TXU spent about \$3.8 million on outside lobbyists, another \$11 million in political advertising, and another \$200,000 on gifts to state officials).

²⁵⁹ R.G. Ratcliffe, *Big Guns Used to Kill Electric Utility Reform*, HOUSTON CHRON., June 2, 2007, <http://www.chron.com/news/article/Big-guns-used-to-kill-electric-utility-reform-1800230.php>.

²⁶⁰ The Texas Lieutenant Governor is considered by many to be the most powerful elected official in the state, particularly when it comes to influencing legislative action. See Dave McNeely, *Who Runs Texas?*, TEX. OBSERVER, July 30, 2010, <https://www.texasobserver.org/who-runs-texas> ("[a] long standing argument is that the lieutenant governor of Texas is more powerful than the governor"); Ben Philpott, *Why is the Lieutenant Governor the Most Powerful Office in Texas? And Who Wants That Power?*, KUT NEWS, Oct. 16, 2014, <http://kut.org/post/why-lieutenant-governor-most-powerful-office-texas-and-who-wants-power> (describing the Lieutenant Governor as the office "that some people say is the most powerful one in Texas").

²⁶¹ The Speaker of the House in Texas is also considered more powerful than most state speakers. This is because following Reconstruction, the drafters of the Texas state constitution intentionally divided power between the Governor, Lieutenant Governor and Speaker positions. See McNeely, *supra* note 260.

²⁶² See R.A. Dyer, *Dewhurst's TXU Ties Are Criticized*, STAR-TELEGRAM, Mar. 22, 2007.

²⁶³ See Ratcliffe, *Big Guns Used to Kill Electric Utility Reform*, *supra* note 259.

²⁶⁴ See Rebecca Smith, *How Shale-Gas Boom Led to Demise of Energy Future Holdings*, WALL ST. J., Apr. 29, 2014, <http://www.wsj.com/articles/SB10001424052702304163604579531644232506988>.

²⁶⁵ See Peter Lattman, *A Record Buyout Turns Sour for Investors*, N.Y. TIMES DEALBOOK, Feb. 28, 2012, <http://dealbook.nytimes.com/2012/02/28/a-record-buyout-turns-sour-for-investors>.

²⁶⁶ See John Bringardner, *Looking to Shed \$40B in Debt, Energy Future Holdings (TXU) Files Ch. 11*, FORBES, Apr. 29, 2014, <http://www.forbes.com/sites/spleverage/2014/04/29/looking-to-shed-40b-in-debt-energy-future-holdings-txu-files-ch-11/#6ed48025e7e3>.

TXU spent a substantial amount of general treasury funds on CPA intended to ensure that its proposed acquisition would go through, and these expenditures were successful in reaching their desired outcome. Ex ante, this acquisition was very much in the interests of shareholders and managers and very much against the interests of outstanding creditors, who suffered significant losses on their investment, both in the near term and in the long term, due to the LBO.

B. Non-Shareholder Agency Costs of CPA Are Substantial

These examples illustrate some of the more spectacular instances of the agency costs posed by CPA for non-shareholders, but do not represent more than a narrow slice of the potential agency conflicts that can arise, and are not meant to encompass all of the different ways in which CPA might create agency costs for non-shareholders. Other types of CPA, such as lobbying against pro-union or pro-worker laws and regulations, would clearly run against employee interests. Creditor interests might be harmed by CPA that pushes for certain types of changes in bankruptcy law or the regulation of credit rating agencies, who play a critical role in many debt offerings. It is almost impossible to imagine all of the different ways in which corporate stakeholders might have conflicts over CPA, because to do so requires us to think about all of the different ways in which the law might be changed to benefit shareholders and harm other corporate stakeholders. Unfortunately, in the absence of any empirical data, it is impossible to know how large of a problem the non-shareholder agency costs of CPA might be.

Given that the types of agency conflicts here—creditor-manager, creditor-shareholder, employee-manager, employee-shareholder—can result in considerable costs in the general corporate governance context, as Part II.B describes, it seems likely that they are also quite substantial in the context of CPA. Moreover, the sheer size of the economic investments that non-shareholders hold in the firm makes it logical to assume that these potential agency problems are quite large in pecuniary terms as well. Debt investors are a huge source of financing for corporations, particularly the large, publicly traded corporations that are most active in the political arena. Employees are also critical to the success of the firm. While it is difficult to measure the quantitative value of their importance to the firm, or the value of their human capital investments, they are clearly enormous. The agency costs that these non-shareholders face may be larger than those faced by shareholders, given that non-shareholders are even further removed from the mechanisms of control than shareholders. Moreover, as the interests of insiders become more aligned with those of shareholders, a larger potential conflict emerges between the corporation and its non-shareholder constituents.

IV. “Procedures of Corporate Democracy” Do Not Address Non-Shareholder Agency Costs of Corporate Political Activity

The high agency costs that CPA produces for non-shareholders raise an obvious question: whether these agency costs are, or potentially can be, contained by the existing corporate governance infrastructure, either through corporate law or private ordering. There are really two analyses here that must be undertaken. First, does corporate law control non-shareholder agency costs arising from CPA?

Second, can private ordering solutions address these costs? This Part looks at the first question and concludes that corporate law is unlikely to ameliorate the agency cost problem that CPA raises for non-shareholders. It then turns to the second question and argues that private ordering is unlikely to be effective due to large economic frictions.

A. Theoretical Arguments for Shareholder Primacy Are Unpersuasive for CPA

As Part II describes, corporate law and corporate governance are generally understood to embody, if imperfectly, the principles of shareholder primacy, and this ordering is thought to be the normatively correct outcome. This claim centers on the assertion that shareholder primacy is the arrangement that corporate stakeholders would themselves agree to in most circumstances, in the absence of transaction costs. Because there are high transaction costs, corporate law should reflect the terms of this hypothetical bargain, so as to maximize the efficiency of corporate capital formation. This insight provides a powerful normative justification for shareholder primacy in corporate law.

This argument rests critically on two claims. First, as residual claimants, shareholders have the best incentives to maximize the expected utility for all stakeholders, since they receive only what is left after all of the fixed claimants are paid. Second, non-shareholders, as fixed claimants, are better situated to contract for covenants that advance their interests or to seek the protections offered by external laws. In other words, non-shareholders are protected by law and their capacity to contract, and shareholders are best positioned to steer the corporation to act in ways that benefit all stakeholders.

But while this argument may be persuasive for corporate governance generally, does it also hold as a justification for shareholder primacy in the firm's decision to engage in CPA? Somewhat surprisingly, this is a question that has not yet been addressed in the post-*Citizens United* literature.²⁶⁷ Virtually all of the corporate law-based analysis of corporate political speech since that decision has assumed shareholder primacy as a starting point and focused on agency issues between shareholders and managers.²⁶⁸ No one has yet looked closely at the underlying question of whether shareholder primacy is the appropriate norm for CPA. Indeed, as I demonstrate in this Part, the main theoretical arguments for shareholder

267. David Yosifon thoughtfully explores some of the issues that corporate political speech raises for the nexus-of-contracts approach in the aftermath of *Citizens United*, but does not address the threshold question of whether shareholder primacy should govern corporate political activity. See generally David G. Yosifon, *Discourse Norms as Default Rules: Structuring Corporate Speech to Multiple Stakeholders*, 21 HEALTH MATRIX: J. L.-MED. 189 (2011) [hereinafter Yosifon, *Discourse Norms*]; David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After Citizens United*, 89 N. CAR. L. REV. 1197 (2011). Instead, Yosifon focuses on the types of communications made by corporations and concludes that we ought to look to what the “discourse norms” are for these types of communications to determine what the default rules should be. For example, Yosifon argues that the “practical and moral expectations” that are present in commercial advertising, including boundaries on the level of “puffery” and misleading advertising, should guide our understanding of the default rules around corporate communications in this space. Yosifon, *Discourse Norms*, *supra*, at 195-203.

268. A partial but representative list of this scholarship can be found *supra* at note 1.

primacy in corporate governance generally are inapt when it comes to corporate political activity.

1. CPA Creates a Private Rent-Seeking Problem that Diminishes the Residual Claimant Incentives Argument

As discussed in Part II.C, one key justification for shareholder primacy is the idea that shareholders, as residual claimants, have the best incentives to guide the corporation in the interests of all stakeholders. This argument may have some persuasive appeal for general business activities, the benefits of which appear in the form of revenues that flow into the general treasury and are distributed according to each stakeholder's relative priority of claims. When it comes to CPA, however, the residual claimant argument falls apart. Certainly, many types of CPA can be understood to benefit all corporate stakeholders, and thus can be properly described as Pareto-efficient. For example, CPA that results in the elimination of redundant or unnecessary regulation that negatively impacts the firm's business would be positive for the business as a whole, and thus in the interests of all stakeholders. This type of Pareto-efficient CPA is not different in kind than any other investment by the firm, insofar as the benefits that accrue from it are directed to the general corporate treasury, and distributed to all corporate stakeholders according to their priority.

But as the analysis in Part III illustrates, many forms of CPA are intended to result in legal or regulatory changes that primarily or solely benefit a subset of corporate stakeholders. These types of CPA can be thought of as rent seeking activities, insofar as they seek to benefit some stakeholders at the direct expense of other stakeholders.²⁶⁹ Of course, most CPA likely falls somewhere in between Pareto-efficient and rent-seeking, providing some benefits to the corporation as a whole but primarily or wholly directing these benefits to certain classes of stakeholders. But to the extent that some CPA is driven at least in part by rent seeking motivations, this undermines the normative argument for shareholder primacy.

For example, political action that makes it difficult for employees to bargain collectively benefits shareholders but harms employees. Political action that increases the firm's risk of insolvency benefits shareholders but harms creditors. Political action that reduces dividend taxes benefits shareholders but not other stakeholders (at least not directly). And of course, as described in Part III, political action that allows a firm to increase its risk of insolvency may be beneficial to

269. While the term "rent-seeking" is often associated with political lobbying and other efforts meant to influence politicians to provide some form of monopoly rents, the term is also used to describe non-productive competition for surplus value *within* the firm. See discussion *supra* note 64; see also MARK ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 128 (2003) (stating that "[c]ompetition for rents . . . is not just *between* firms but also *inside* firms as the players *inside* the firm—shareholders, managers, employees, compete to grab a piece of [surplus profits]"); Blair & Stout, *supra* note 4, at 249 (describing rent seeking as competition between different corporate stakeholders to capture the surplus generated by the firm). Bainbridge argues that a greater emphasis on shareholder primacy has led to greater rent-seeking between shareholders. BAINBRIDGE, NEW CORPORATE GOVERNANCE, *supra* note 138, at 228-32 (citing Lynn Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 794-95 (2007) (describing the problem of *intershareholder* rent-seeking)).

shareholders while harming the interests of creditors and employees. The risk of private rent-seeking raised by CPA upends the logic that shareholders, as residual claimants, have the appropriate incentives to ensure that all of the fixed claimants, who are senior in payment priority, get paid first. Thus, this crucial contractarian argument for shareholder primacy may be unpersuasive for CPA.

2. CPA Can Circumvent Contractual Covenants and External Laws

CPA also undermines the other core justification given by contractarians for shareholder primacy, namely, that non-shareholder interests are better situated to be protected by contract and by external laws. If external laws are seen as a valid means to limit the agency costs of non-shareholders, then these are necessarily exogenous to shareholder primacy itself. That is to say, the claim that shareholders should be prioritized because the availability of external laws mitigates non-shareholder conflicts with shareholders only makes sense if the firm itself cannot modify those external laws. If corporations, acting on behalf of shareholders, can change or eliminate the laws that protect non-shareholder constituents, then it is incoherent to claim that non-shareholder interests are protected by these laws. Since CPA has the potential to change the external laws upon which non-shareholders rely, it naturally follows that shareholder primacy should not govern for CPA.

Another argument for shareholder primacy in corporate governance is that non-shareholders can gain protection through “negative covenants” that limit the behavior of the corporation in ways that can minimize non-shareholder agency costs. This assertion also relies on an unstated but crucial assumption of exogeneity, namely, that the contractual rights negotiated by each set of parties at the time of contracting are static and impervious to the firm’s own activities. But that is not necessarily the case with CPA, which can change the background legal rights and ordering that were baseline assumptions at the time of contracting. For example, when a creditor negotiates a particular level of seniority in her claims, she negotiates her priority against a background of legal expectations that are thought to be immutable. But as Roe and Tung have pointed out, political activity can even change creditor priorities in bankruptcy.²⁷⁰ Thus, just about any contractual provision that one could imagine writing to protect non-shareholder interests could potentially be co-opted by CPA. A contractual provision setting the minimum wage for a company’s employees at \$10 an hour could be effectively eliminated by political action that creates greater inflation or allows the firm to eliminate employee benefits. A covenant requiring that a company maintain a certain leverage ratio could be effectively bypassed by the SEC’s adoption of new accounting rules that allow the company to reclassify how it accounts for certain liabilities (such as with potential changes to mark-to-market accounting). Thus, the claim that non-shareholder interests are well protected through contract seems inapt, or at least less apt, when it comes to CPA.

270. Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors’ Bargain*, 99 VA. L. REV. 1235, 1238-41 (2013) (describing how creditors have “jumped priority” through lobbying and other political activities targeted at Congress and federal administrative agencies such as the Securities and Exchange Commission).

Moreover, if we revisit the hypothetical bargain scenario at the heart of the nexus-of-contracts approach, it is also difficult to imagine why and under what circumstances non-shareholders would concede to shareholders the unlimited use of corporate funds to try to change the laws and regulations that are in place at the time the bargain is struck, without any consultation or approval from non-shareholders. Shareholders and non-shareholders alike place great monetary value on legal certainty,²⁷¹ and corporate contractarians have noted in advocating for shareholder primacy that external laws provide great value to non-shareholders in protecting their interests.²⁷² It therefore seems unlikely that non-shareholders would submit to a bargain in which shareholders could utilize general corporate treasury funds—to which all of the corporation's stakeholders contribute and claim entitlement—to advance their own political and economic interests, given the sharp potential divergence between shareholders and non-shareholders in this regard, and the possibility of rent-seeking described above.

For general business activities, the shareholder primacy norm does not seem to have the potential to impact the legal framework in place. Thus, the contractarian claim that non-shareholders would concede shareholder primacy may be persuasive. However, CPA is quite different, in that it is often pursued precisely for the purpose of influencing the basic legal background against which the corporation—and any hypothetical contractual arrangements that might justify shareholder primacy—was formed. It therefore seems untenable to claim, as the contractarian argument for shareholder primacy does, that the shareholder primacy norm reflects the default rules of corporate private ordering when it comes to the firm's decision to engage in CPA.

3. Corporate Law Does Not Effectively Resolve Non-Shareholder Agency Costs of CPA

When it comes to general corporate business decisions, there are very good arguments for elevating the interests of shareholders above the interests of other stakeholders. But in the context of CPA, as the above analysis indicates, the usual mechanisms for reducing non-shareholder agency costs may be unavailable. Furthermore, non-shareholders do not have recourse to the various “procedures of corporate democracy” that are available to shareholders.

Thus, because of the strong conflicts between shareholders and other corporate constituencies, it seems likely that shareholder primacy would actually worsen rather than alleviate the problem of non-shareholder agency costs arising from CPA. To the extent that corporate law is broadly understood today to prioritize the

271. See generally Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decision Making—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1 (1985) (discussing the importance of certainty in the valuation of corporate securities); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (noting that legal certainty is a primary reason why so many corporations choose to charter in Delaware); see also Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 GA. L. REV. 525, 623-24 (2005) (stating investors would “likely apply a heavy discount to the securities of issuers” in the absence of legal certainty).

272. See *supra* Part II.C.2.

interests of shareholders over other corporate stakeholders, it does not appear to be a likely avenue to solving the non-shareholder agency cost problem.

B. Private Ordering Does Not Address Non-Shareholder Agency Costs of CPA

While corporate law may not suffice to protect non-shareholder interests in CPA, what about private ordering and market responses? In general, corporate law scholars tend to assume that creditors and employees are best protected by private law solutions, particularly contractual covenants. If, as the analysis in Part III suggests, CPA poses significant potential problems for the interests of non-shareholders, the natural place to look for solutions would be in private law.

Private law solutions to the agency cost problems raised by CPA have not been greatly explored or discussed.²⁷³ To the extent that corporate stakeholders may have strong interests in limiting CPA, as described in Part II above, there appears to be some potential for private ordering to provide a regulatory solution to the agency costs created by CPA. Could corporate stakeholders negotiate for contractual covenants restricting or regulating CPA as a means of limiting the agency costs that may arise from CPA? As I describe below, covenants have become increasingly studied as a means of addressing creditor agency costs. Contractual solutions to the agency problems raised by CPA could also potentially address employee agency costs.

This Section analyzes how private ordering might work to limit non-shareholder agency costs arising from CPA. Ultimately, I conclude that the hurdles to implementing these types of covenants are so high that they are likely to be quite narrowly limited in their potential application.

1. The Use of Covenants to Address Creditor Agency Costs

Covenants, especially those relating to real property, are as old as contracts law itself.²⁷⁴ They have been a staple of bank loans for quite a long time and have

273. One exception to this is Ganesh Sitaraman's proposal for a quasi-contractual pledge between the two candidates in a particular political race, in which each candidate would promise to donate some set amount of money to charity for each dollar of outside independent expenditures that is spent in support of their campaign. Ganesh Sitaraman, *Contracting Around Citizens United*, 114 COLUM. L. REV. 755, 776-799 (2014). This pledge would not be legally enforceable, but would rely instead on normative sway, and thus its effectiveness ultimately depends on the legitimacy that it derives from the consensus of the political candidates themselves. See Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 327-29 (2002) (describing how rules adopted by private actors without government sanction derive their legitimacy entirely from consensus agreement on the rules themselves). This could be a tricky proposition, as these types of norms typically arise under conditions in which the parties involved have repeat contact with one another, which is not generally the case with political candidates. See Robert Axelrod, *An Evolutionary Approach to Norms*, 80 AM. POL. SCI. REV. 1095, 1097-98 (1986); Jack Hirschleifer, *Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies*, 4 RES. L. & ECON. 1, 33-38 (1982); Eric Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1715-16 (1996). Because this proposal targets the spending of politicians and is not addressed at the agency costs of corporate stakeholders, I do not address it in this Article.

274. For example, restrictive covenants on the transfer of real property go back to the early days of English common law. See R. Geoffrey Rowley, *The Benefit of Restrictive Covenants: A Survey*, 16 MOD. L. REV. 428 (1953).

increasingly become a staple of bond indenture agreements,²⁷⁵ although bond investors rely on them far less.²⁷⁶ They have been ubiquitous in corporate debt agreements, with one recent study finding that almost 97% of all corporate loans contained at least one financial covenant.²⁷⁷ Covenants typically take the form of affirmative covenants, negative covenants, and financial covenants.²⁷⁸ Affirmative covenants require the borrower to take certain actions, such as meeting generally accepted accounting principles, complying with regulatory and legal requirements, and producing periodic disclosure reports.²⁷⁹ Affirmative covenants tend to be limited in scope, because if they are seen as giving creditors too much control over the firm, the corporation may lose its limited liability.²⁸⁰ Negative covenants, as their name suggests, prohibit the borrower from taking certain actions, such as changing control of the company or making excessive capital expenditures.²⁸¹ Finally, financial covenants restrict the borrower from exceeding certain accounting-based ratios and limits, such as leverage ratios, interest coverage, or net worth.²⁸²

One very common type of corporate debt covenant is the dividend covenant, which restricts the payments of dividends based on certain net income thresholds.²⁸³ Other commonly used covenants include: restrictions on debt (typically in the form of leverage ratios),²⁸⁴ restrictions on liens, restrictions on the sale or transfer of assets, restrictions on changes in control, and reporting requirements.²⁸⁵ For covenants to be effective, creditors must be diligent and effective monitors and detect when covenants have been violated.²⁸⁶ One common approach to facilitate better monitoring is to require periodic disclosures of certain types of information and/or to show compliance with covenants on a periodic basis.²⁸⁷

The traditional view of covenants is that they tend to avoid “extensive direction restrictions on production/investment policy” because of the high transaction costs

275. See generally Judy Day & Peter Taylor, *The Role of Debt Contracts and Debt Covenants in Corporate Governance: Reflections on Evolution and Innovation*, in ACCOUNTING AND REGULATION 161, 161-90 (Roberto Di Petra et al., eds., 2014).

276. See Charles K. Whitehead, *Creditors and Debt Governance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 68-69 (Claire A. Hill and Brett H. McDonnell eds., 2012).

277. Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 4 J. FIN. 1657, 1662 (2009).

278. See Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1719-20 (2012) [hereinafter Nini et al., *Creditor Control Rights*].

279. *Id.*

280. See Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 352-55 (1991).

281. See Nini et al. *Creditor Control Rights*, *supra* note 278, at 1719-20.

282. *Id.*

283. See, e.g., Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 4 J. FIN. ECON. 211, 217 (1982) (finding that 85% of corporate debt reported by Moody's Industrial Manual from 1956-1975 contained a dividend restriction).

284. See Bratton, *Bond Covenants*, *supra* note 110, at 10-11.

285. *Id.* at 11-15.

286. See, e.g., Raghuram Rajan & Andrew Winton, *Covenants and Collateral as Incentives to Monitor*, 50 J. FIN. 1113 (1995).

287. Nini et al., *Creditor Control Rights*, *supra* note 278, at 1720.

involved with such restrictions.²⁸⁸ The evidence today, however, is that creditors do indeed negotiate for covenants that are extremely specific as to the types of expenditures that are made.²⁸⁹ As a recent but very influential line of literature has articulated, covenants are already a very powerful, if occasionally underutilized, mechanism by which debt investors can control the behavior of corporate managers.²⁹⁰ Baird and Rasmussen go so far as to call contractual covenants the “missing lever” of corporate governance.²⁹¹ Whether or not this is an accurate depiction, it is important to recognize that creditors already rely heavily on covenants to address agency costs. Breaches of contractual covenants not only provide the potential of legal remedies, but the threat of default that accompanies such breaches, which is also frequently used to negotiate changes in corporate behavior that are advantageous to creditor interests.²⁹² In other words, the violation of covenants gives creditors significant leverage in forcing beneficial changes in corporate governance. Thus, debt investors have increasingly negotiated for covenants that firms are likely to violate,²⁹³ with the expectation that these contractual “trip-wires” will allow them to negotiate additional changes as desired.²⁹⁴ Conversely, firms with better governance require fewer covenants.²⁹⁵

2. High Barriers to Covenants Restricting Corporate Political Activity

As Smith and Warner argued in their seminal paper on creditor covenants, most existing covenants can be understood as mechanisms to try to control creditor-shareholder agency costs.²⁹⁶ Of course, until recently, much of the shareholder-creditor conflict around CPA was addressed by state and federal campaign finance laws, so there was no need for CPA-related covenants. As a result, there are currently no covenants that deal with corporate political activity, as far as I am aware. There are good reasons for this, some of which I discuss below. But the fact that PAR covenants have not yet been negotiated does not mean that they are not feasible or enforceable. As Bratton has astutely observed, “Nothing in a protective statutory regime prevents a financial creditor from negotiating for stricter

288. Smith & Warner, *supra* note 107, at 117.

289. See generally Nini et al., *Creditor Control Rights*, *supra* note 278.

290. See, e.g., Douglas Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance* 154 U. PA. L. REV. 1209 (2006); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995).

291. Baird & Rasmussen, *supra* note 290.

292. See Nini et al., *Creditor Control Rights*, *supra* note 278.

293. See *id.* at 2-3 (finding that 10-20% of creditors report a covenant violation in any given year).

294. See Roberts & Sufi, *supra* note 277, 1660 (showing that only about four percent of covenant violations actually result in the creditor demanding its contractual recourse of full principal repayment within two quarters after the violation, thus illustrating that most lenders utilize covenant violations to negotiate desired changes to corporate behavior).

295. Xi Li et al., *Corporate Governance and Covenants in Debt Contracts* (Apr. 30, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988272 (finding that corporate bond investors demand fewer covenants for contracts with corporations that have stronger corporate governance structures).

296. Smith & Warner, *supra* note 107.

protection.²⁹⁷ Indeed, the basic mechanisms by which PAR covenants would seek to restrict corporate political activity are conceptually very similar to the extensive activity restrictions that *already* are utilized in credit agreements.²⁹⁸ Similarly, PAR covenants requiring disclosure of CPA are consistent with the reporting requirements already used in covenants.²⁹⁹

Unfortunately, while PAR covenants may be practicable in the context of contractual covenants, they face large economic frictions that make them extremely difficult to implement in practice. This includes the high “stickiness” of covenants, which do not typically adapt very efficiently to changing conditions, and the high transaction costs involved in writing, monitoring, and enforcing such covenants.

a. Sticky Covenants

As a growing body of literature has described, covenants tend to suffer from great “stickiness”—in other words, they tend to remain relatively constant over time—resulting in a high and often suboptimal use of standardized terms. This is true to some degree of all contractual terms used in complex commercial transactions, in which lawyers heavily rely upon existing boilerplate to draft contracts.³⁰⁰ Corporate contracts generally have more stickiness than other types of contracts.³⁰¹ Public debt contracts are among the stickiest types of contracts, with boilerplate terms tending to persist across all offerings, even when they are suboptimal.³⁰² Syndicated loans and private placements also have relatively sticky covenants.³⁰³ Additionally, covenants tend to be cyclical, with debt contracts exhibiting more covenants during periods of tighter credit, and fewer covenants during periods of loose credit.³⁰⁴ Covenants’ high degree of stickiness and cyclicity mean that new covenants, even those that are optimal for creditor interests, tend to be introduced in uneven, inefficient ways, and sometimes not at all.

297. Bratton, *Bond Covenants*, *supra* note 110, at 4.

298. See generally Nini et al., *Creditor Control Rights*, *supra* note 278.

299. *Id.*

300. See MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (2012).

301. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774-815 (1995) (demonstrating that various network externalities and learning effects cause inertia in the adoption of contract terms).

302. See *id.* at 816-19; see also Gus DeFranco et al., *Sticky Covenants* (Chicago Booth Initiative on Global Markets, Working Paper No. 94, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2288723 (providing a literature review of the evidence that public bond covenants are highly rigid).

303. See, e.g., Sudheer Chava & Michael R. Roberts, *How Does Financing Impact Investment? The Role of Debt Covenants*, 63 J. FIN. 2085 (2008); Cem Demiroglu & Christopher M. James, *The Information Content of Bank Loan Covenants*, 23 REV. FIN. STUD. 3700 (2010); Ilia D. Dichev & Douglas J. Skinner, *Large-Sample Evidence on the Debt Covenant Hypothesis*, 40 J. ACCT. RES. 1091 (2002); Stephen Drucker & Manju Puri, *On Loan Sales, Loan Contracting and Lending Relationships*, 22 REV. FIN. STUD. 2835 (2009); Justin Murfin, *The Supply-Side Determinants of Loan Contract Strictness*, 67 J. FIN. 1565 (2012).

304. See Choi & Triantis, *supra* note 151, at 53-56.

b. High Transaction Costs

There are multiple types and classes of creditors, with a partial list including senior secured creditors, bond investors, subordinated debt investors, trade creditors, tort victims, and the Internal Revenue Service.³⁰⁵ As previously noted, these different classes of corporate debt are usually divided into two broad categories: public debt, which consists of publicly offered bonds, and private debt, which consists of bank loans and privately placed bond issues.³⁰⁶ Most corporate debt is private debt. For example, in 2003, \$1.1 trillion of the \$1.6 trillion in corporate debt issued that year was private debt.³⁰⁷ Both public and private debt investors utilize covenants. Bank loans employ term loan agreements; private placements rely on note purchase agreements; and public bonds use debenture indentures to lay out the terms of the agreement between the firm and its creditors.³⁰⁸ All of these types of contracts tend to rely on standardized terms, which have developed slowly over time.³⁰⁹ Public and private debt have many distinct characteristics, so it is worth briefly describing the differences between the two.

Typically, the public debt market is associated with large, publicly traded companies with lower degrees of leverage, broadly available public information (including through SEC filings), and higher credit quality. These are, of course, the types of for-profit companies that are most active in CPA.³¹⁰ Moreover, investors in publicly offered corporate bonds tend to be seeking safer, higher-quality investments, so they have sharp conflicts with shareholders as far as their tolerances for firm risk. Thus, public bond investors seem like ideal candidates to *want* to implement covenants restricting corporate political activity, since they have a low threshold for risk and face high agency costs from CPA.

305. Rock, *supra* note 98, at 1929.

306. There are many different types of corporate bonds, and some of these are more closely held, and thus more closely resemble private loans than publicly issued bonds with large numbers of investors. See Kwan & Carleton, *supra* note 106, at 910; Smith & Warner, *supra* note 107, at 149-50 (noting that relying on trustee monitoring entails agency costs of its own, as “[t]he trustee will . . . not act entirely in the bondholders’ interest. This is particularly true because the extent to which the trustee can be held negligent is limited . . .”).

307. See Arena, *supra* note 106, at 392. However, as Whitehead points out, the division between “public” and “private” debt is increasingly becoming outdated. Advances in the capital markets have meant that most “private” bonds and many “private” loans are increasingly being funded via a wide array of investors, and the actual credit risk is widely dispersed through the use of derivatives and other capital market innovations. Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 661-68 (2009).

308. Bratton, *Bond Covenants*, *supra* note 110, at 41.

309. *Id.*

310. It is difficult to ascertain who exactly is responsible for CPA, given the opacity of these types of expenditures. That being said, the available evidence suggests that large, publicly held corporations are responsible for the vast majority of such activity. For example, Strategas Research Partners developed a “K-Street Index” of the fifty corporations that most intensively lobbied the federal government. This list was made up entirely of large, publicly traded corporations, and included such blue chip corporations as Altria, Amgen, Boeing, Darden Restaurants, Eli Lilly, FedEx, H&R Block, Lockheed Martin, MasterCard, McGraw-Hill, Monsanto, Northrop Grumman, Qualcomm, Raytheon, Tyson Foods, and United Parcel Service. See Nicholas Bohnsack, *Investment & Sector Strategy*, STRATEGAS RESEARCH GRP. (May 2010), http://www.portolagroup.com/media/PGI_Q2_2010_CC_Slides.pdf.

Unfortunately, public bonds also have very high transaction costs, due to the wide dispersion of these instruments.³¹¹ Corporate bonds face costly loan monitoring problems, which results either in duplication of effort or a free rider problem.³¹² This, in turn, creates severe collective action and coordination problems. And while information about the firm's credit characteristics is often widely available through SEC filings and other public disclosures, this is not the case with respect to corporate political activity, which is still quite opaque and undisclosed. As John Coates has described:

All empirical studies of CPA are challenged by the fact that only certain kinds of CPA are required to be disclosed, even by public companies. If Exxon hires a registered lobbyist or lobbying firm to act as such, the lobbyist and/or firm must disclose that fact, but nothing requires Exxon to disclose the fact that it may hire a law or public relations firm (not registered as a lobbyist) that engages in activities that are essentially political in nature, and would be identified as "lobbying" in ordinary speech. Books, television ads or appearances, op-eds, pamphlets, congressional testimony, efforts to stimulate "grass-roots" letter-writing campaigns, public comments on proposed regulations, and all lobbying activities by those whose lobbying activities constitute less than 20 percent of the time engaged in services are all arguably exempt from the legal definition of "lobbying contacts," depending on the facts. Lobbying disclosure laws are also largely unenforced Even contributions and election expenditures are exempt from disclosure if carefully funneled through "conduits," that is, "independent" organizations.³¹³

The lack of information about CPA is particularly problematic for public bonds, because the widely dispersed investors in this type of debt face high monitoring costs and a free rider problem. In short, high transactions costs block public bond investors from seeking political activity restriction covenants that they would otherwise be inclined to obtain.

Perhaps because of these higher transaction costs, bond investor governance is generally seen as less effective than bank lender governance. It can still sometimes be effective in monitoring and managing agency costs, though, especially if information and coordination issues are mitigated.³¹⁴ The increasing sophistication of bond investors, including the emergence of hedge funds, vulture funds, and asset management firms, may have improved the conditions for bondholder governance by reducing collective action and free rider problems.³¹⁵

In short, investors in public debt likely have the incentives to negotiate for PAR covenants, but high transaction costs, coupled with the stickiness of bond covenants

311. See Denis & Mihov, *supra* note 106 (reviewing the literature on public debt and finding that public debt tends to be issued by the largest, high-credit-quality corporations, likely due to the high transaction costs facing these investors).

312. See generally Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393, 393-94 (1994) (stating that the problem of costly monitoring of loan contracts creates either a duplication of effort or a free-rider problem among bondholders). In practice, the covenants of publicly offered bonds are enforced by the bond's trustee, who is appointed and paid by the borrowing firm and thus is not a particularly strong monitor or enforcer of investor interests.

313. Coates, *supra* note 1, at 661.

314. See, e.g., Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?*, 66 J. BUS. 499, 500-01 (1993).

315. See Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 284-92 (2009).

described above, mean that there are some serious hurdles to amending bond indentures to include these types of covenants.

On the other hand, private debt investors tend to face smaller transaction costs and therefore use covenants more frequently and effectively. Investors in private debt tend to be commercial banks and life insurance companies that specialize in evaluating credit risk, and thus tend to be better suited to bridge the information asymmetries that exist in debt investments.³¹⁶ Smaller and/or distressed corporations, who have fewer available options and therefore less bargaining power, tend to rely more heavily on private debt, which is typically costlier and is accompanied by more and more intrusive covenants.³¹⁷ Thus, private debt investors wield disproportionate control in the governance of smaller and/or distressed companies.³¹⁸ As a result, private debt investors investing in smaller companies are better situated both to secure access to greater information about the firm's activities,³¹⁹ and to more successfully assert demands on the corporation issuing debt.³²⁰ So while public bond investors face high barriers to monitoring and enforcing covenant terms, and thus utilize them less frequently, private debt investors have relatively low transaction costs and utilize covenants aggressively, including as "tripwires" to provide them with more leverage to negotiate key changes.³²¹

But while private debt investors might be better situated to negotiate for and enforce covenants restricting corporate political activity, they may be less inclined to do so. Corporations that are smaller and possibly near insolvency are the ones that rely most heavily on private debt and agree to the types of covenants that give creditors greater control.³²² These are not generally the types of companies that are engaging in high levels of CPA.

3. Pricing and Exit Are Also Problematic Solutions for Non-Shareholder Agency Costs

While covenants may be unlikely to address non-shareholder agency costs arising from CPA, another way in which debt investors might exert some measure of governance on agency problems is through traditional market mechanisms—demanding increased yields for the greater risk involved with CPA, or by selling their debt. Again, because the issue of non-shareholder agency costs of CPA has

316. See Sudha Krishnaswami et al., *Information Asymmetry, Monitoring, and the Placement Structure of Corporate Debt*, 51 J. FIN. ECON. 407, 408 (1999).

317. *Id.*; see also Denis & Mihov, *supra* note 106 (describing how credit quality of the debt issuer is a key factor in the choice of debt financing used, with the highest quality firms tending to choose more public debt, and lower quality firms choosing private debt).

318. Baird & Rasmussen, *supra* note 290, at 1231-33.

319. See generally Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY ECON. 29, 37-38 (1985) (describing the comparative advantage of banks in securing information about borrowers).

320. See Thomas J. Chemmanur & Paolo Fulghieri, *Reputation, Renegotiation, and the Choice Between Bank Loans and Publicly Traded Debt*, 7 REV. FIN. STUD. 475, 476-79 (1994); Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1190-92 (1991).

321. See Chemmanur & Fulghieri, *id.* at 476-79.

322. See *supra* note 106 for authorities describing this point.

not been a subject of study, there is no empirical research focused specifically on whether and how non-shareholders react to CPA in terms of their pricing or purchase decisions. But research on creditor discipline generally provides us with some insights on this question.

As previously discussed, creditors are broadly divided into two categories—private debt investors and public debt investors. Private debt investors are better constituted to bridge the informational asymmetries involved in corporate debt investment. They also tend to provide a greater share of debt financing to corporations that are smaller or more distressed. Thus, private debt investors are well equipped to monitor and enforce business decisions that are adverse to their interests. Conversely, investors in public debt tend to be more diffuse, with less access to information, less capacity to monitor the firm's activities, and large coordination, collective action, and free rider problems. Thus, in general, investors in public debt have tended to be associated with larger corporations with high credit quality—generally, the type of debt issuer that creates the largest potential agency problems arising from CPA.

As discussed above, most CPA (at least among for-profit corporations) comes from large corporations, which rely more heavily on public debt. Given that public debt investors generally are seen as poor monitors facing high informational asymmetries, the idea that pricing or exit by debt investors in these companies can meaningfully constrain the agency costs created by CPA seems dubious. The firms that create the highest agency costs from their CPA are also the firms that have the steepest information asymmetries and rely most heavily on debt investors who are poorly equipped to monitor and discipline adverse corporate decisions.³²³

V. Implications and Potential Solutions

The Court's decisions, beginning in the 1970s and continuing through *Citizens United*, have effectively created a Kafkaesque situation for non-shareholders when it comes to CPA. Non-shareholders face legitimate conflicts of interest with both corporate insiders and the shareholders whose interests corporate law tells us should be prioritized in the governance of the firm. And while the exact scope and breadth of this problem still needs significant exploration, it is clear that the costs of this conflict can be astronomical.

But even as it is clear that CPA presents significant agency costs for non-shareholders, it appears that there are no viable solutions for this problem, either in corporate law or in private ordering or market mechanisms. Ordinarily, we would expect government regulation to address such a major market failure, where a significant and costly problem exists and is not remedied by private market-based solutions. But in the case of CPA, the Court's expansive view of corporate political speech rights, without any serious analysis of the agency problems that are at the heart of the decision to engage in CPA, has estopped state or federal governments from providing such a regulatory solution.

In short, whatever we may think of the constitutional merits of *Bellotti* and *Citizens United*, an examination of the agency problems that CPA creates for non-

323. See generally Min, *supra* note 173 (describing the failure of debt investors in AAA-rated bank liabilities to react to rising risk).

shareholders demonstrates that these decisions create very bad public policy. This Part looks into the problems created by the Court's jurisprudence and explores several options for trying to address them.

A. Restricting Corporate Political Activity

Having established in Part III that shareholder primacy, which clearly governs general corporate business activities, should not be the norm for corporate political activity, what then might be the default rules for CPA? To answer this question, it is useful to revisit the hypothetical bargain approach described in Part I. What terms might corporate stakeholders agree upon for governing CPA, in the absence of transaction costs?

To get a sense of this, consider the dynamics that each set of stakeholders face. CPA potentially creates very high agency problems, and—unlike general business decisions—any particular decision to engage in CPA can lead to an intractable rent-seeking problem, wherein one class or subclass of stakeholders is able to use firm resources to change the underlying legal and contractual “rules of the game” in an effort to benefit only itself, possibly while harming other stakeholder classes. Thus, CPA can upend the external laws and contractual provisions that economists and corporate law scholars tend to assume can mitigate non-shareholder agency problems. Thus, the potential agency costs of CPA are quite large. And while many types of CPA are Pareto-efficient, as described in Part III.B, there is simply no way that non-shareholders can determine *ex ante* whether the firm will engage in CPA. In other words, CPA raises severe post-contractual opportunism problems for non-shareholders that cannot be sufficiently addressed through contract or other private ordering mechanisms.

The solution to post-contractual opportunism, for shareholders, is to simply prioritize their interests in corporate governance. However, this solution does not work for all stakeholders, since we cannot prioritize the interests of all stakeholders. Thus, corporate law, even assuming that it could be amended to reflect a reordering of interests, does not appear to be an appropriate avenue for addressing the problems that CPA raises for non-shareholder interests.

This analysis suggests that perhaps the most efficient rule is the one that was in place for centuries prior to the Court's momentous decision in *Bellotti*—a ban on some or all forms of CPA, administered either through a reinvigorated *ultra vires* doctrine or through campaign finance laws. Given the high agency costs imposed on non-shareholders by CPA, the lack of viable private ordering solutions for addressing this problem, and the problems that shareholder primacy, or the primacy of any class of stakeholders, raises for the interests of other stakeholders, such a ban would seem the most efficient way to address these agency cost problems, and it would be easiest and cheapest to administer as well.

Moreover, to the extent that we are concerned about the capacity of corporate stakeholders to continue to engage in positive-sum CPA, a vehicle for promoting such activities, relying entirely on voluntary contributions from interested corporate stakeholders, already exists—the PAC (sometimes known as the separate

segregated fund).³²⁴ Corporations are barred from directly donating general treasury funds to political candidates under the Tillman Act of 1907.³²⁵ However, this prohibition did not prevent corporations (or other organizations, including labor unions) from persuading their stockholders and other interested parties to establish separate, voluntarily funded political action committees.³²⁶ Corporate PACs have played a critical role in the financing of political campaigns since at least 1974, when amendments to the Federal Election Campaign Act were enacted that facilitated their creation.³²⁷ Corporate PACs may solicit voluntary contributions from corporate shareholders, officers, and managers (and the families of these individuals), and spend on political activities that are pronounced to be in the corporation's interest.³²⁸ The importance of PACs was further heightened with the passage of the Bipartisan Campaign Reform Act of 2002 (BCRA, popularly known as "McCain-Feingold"), which, among other things, banned corporations from using their general treasury funds to finance "electioneering communications"—television or radio advertisements that feature a candidate for federal office, are capable of reaching 50,000 people, and are aired thirty days before a primary or sixty days before a general election.³²⁹

At least in theory, PACs should be able to marshal voluntary contributions from those corporate insiders and shareholders interested in advancing their shared political objectives, and they should be able to do so in a way that largely eliminates the agency cost concerns that exist for CPA.³³⁰ But what of the costs of setting up and operating PACs? The majority opinion in *Citizens United* was deeply concerned with what it saw as the high costs of maintaining segregated political funds. Justice Kennedy wrote for the majority:

324. See FED. ELECTION COMM'N, NONCONNECTED COMMITTEES 1 (2008), <http://www.fec.gov/pdf/nongui.pdf>.

325. Tillman Act of 1907, ch. 420, Pub. L. No. 59-36, 35 Stat. 864 (1907) (codified as amended at 2 U.S.C. § 441b). This prohibition was later applied to labor unions under the Labor Management Relations Act of 1947, ch. 120, tit. III, 61 Stat. 159 (1947) (codified as amended at 2 U.S.C. § 441b).

326. Ironically, these PACs were first utilized and popularized by labor unions. See *Pipefitters Local Union No. 562 v. United States*, 407 U.S. 385, 402-09 (1972) (discussing the history of the CIO Political Action Committee and union-organized PACs, which first came to prominence with the 1944 election).

327. Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443, 88 Stat. 1263 (1974) (codified as amended at 2 U.S.C. §§ 431-55). As Judge Skelly Wright describes, the 1974 Act contained several important legal changes that spurred the rapid growth of corporate PACs, including a reversal of a longstanding ban on political activity by government contractors, important clarifications on the limits of solicitation by corporate PACs, and limits on individual and party contributions (which made PACs a relatively more important source of campaign funds). J. Skelly Wright, *Money and the Pollution of Politics: Is the First Amendment an Obstacle to Political Equality?*, 82 COLUM. L. REV. 609, 614 n.35 (1982).

328. See 2 U.S.C. § 441b(b)(3)(C), *invalidated in part by Citizens United v. FEC*, 558 U.S. 310 (2010) (current version at 52 U.S.C. § 30118 (2012)).

329. Bipartisan Campaign Reform Act of 2002, Pub. L. No. 107-155, §§ 203, 116 Stat. 91 (2002) (codified as amended at 2 U.S.C. § 441b, now transferred to 52 U.S.C. § 30118 (2012)); see also Richard L. Hasen, *Citizens United and the Illusion of Coherence*, 109 MICH. L. REV. 581, 588-89 (2011).

330. But see HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE CORPORATION AND THE CONSTITUTION* 66-67 (1995) (arguing that, because corporate PACs solicit funds primarily from managers, these funds may reflect managerial interests more than shareholder interests).

PACs are burdensome alternatives [to direct corporate political expenditures]; they are expensive to administer and subject to extensive regulations. For example, every PAC must appoint a treasurer, forward donations to the treasurer promptly, keep detailed records of the identities of the persons making donations, preserve receipts for three years, and file an organization statement and report changes to this information within 10 days PACs must file detailed monthly reports with the FEC³³¹

And yet, despite what the *Citizens United* majority saw as overly burdensome costs and regulation, PACs have undeniably been incredibly effective at raising and spending money on political activities. In the 2008 election, the last before *Citizens United* upended the regulatory framework restricting direct CPA, corporate PACs dominated campaign finance, accounting for one out of every ten dollars received by candidates running for federal office.³³² In total, PACs raised \$1.5 billion and contributed \$416 million during the 2008 election cycle.³³³

Certainly, the costs of PACs are a relevant factor in evaluating their overall effectiveness. But such costs should not be considered in a vacuum, without comparing them to the enormous and unsolvable agency costs that exist for CPA. Indeed, most of the “burden” described by Justice Kennedy simply reflects the costs of monitoring the PAC’s political activities, costs that would otherwise be part of the agency costs borne by corporate stakeholders. When compared with the high potential agency costs of CPA, PACs seem like a reasonably efficient and cost-effective vehicle for collecting and marshaling the funds of corporate stakeholders to the political causes that benefit their interests.

In short, the high agency costs raised for all stakeholders by CPA, the severe and apparently intractable problem of rent-seeking between stakeholders that CPA creates, the lack of viable solutions for this problem in corporate law or private ordering, and the availability of an effective alternative in PACs for promoting voluntary, “positive-sum” CPA all lend support to the conclusion that CPA should be outside the acceptable activities of the corporation.

B. Bellotti and Citizens United Create Bad Public Policy

The above analysis illustrates that, whatever their merits as constitutional decisions, *Bellotti* and *Citizens United* create a severe public policy problem. As the analysis in the previous section suggests, regulatory restrictions on CPA appear to be justified by non-shareholder agency costs. Unfortunately, these regulatory solutions are effectively estopped by the Court’s expansive view of corporate political speech protections under the First and Fourteenth Amendments, as articulated most notably in *Bellotti* and *Citizens United*.³³⁴ Whether or not these decisions are compelling from a constitutional law perspective is outside the scope

331. 558 U.S. at 337-38.

332. Ciara Torres-Spelliscy, *Corporate Political Spending and Shareholders’ Rights: Why the U.S. Should Adopt the British Approach*, in RISK MANAGEMENT AND CORPORATE GOVERNANCE 391, 396 (Abol Jalilvand & A.G. Malliaris eds., 2012).

333. *Political Action Committees*, CTR. FOR RES. POL’Y, <http://www.opensecrets.org/pacs> (last visited Feb. 12, 2016).

334. For example, the *Citizens United* majority opinion stated that the government “may not suppress corporate political speech altogether.” 558 U.S. at 319.

of this Article, but from a policy perspective, these decisions create frictions within corporate ordering. By outlawing the implementation of regulatory restrictions, the Court has ensured that the agency costs of CPA will remain high for non-shareholders. This is not just a problem for these stakeholders, but has broader implications for capital formation. As a long line of literature has noted, larger agency costs lead to a higher cost of capital.³³⁵ Thus, to the extent that the Court's robust corporate political speech jurisprudence has co-opted regulations that reflect the efficient default rule of corporate ordering, this imposes costs, potentially very high ones, on American capital formation through the corporate form.

Because the issue of non-shareholder agency costs in the firm's decision to engage in CPA has not yet been studied, the volume and broader economic impact of these agency costs are unclear. But based on the importance of creditor and employee interests in and to the firm, and based on the potential size of the agency conflicts involved, it seems likely that the impact on capital formation is large. One set of evidence that may bear on this issue lies in a very new strand of research purporting to identify a link between states' creditor-protective legal rules and lower-cost debt funding.³³⁶ This line of research suggests that capital formation and corporate funding costs are significantly affected by legal "default rules" that also impact non-shareholder agency costs.

C. Non-Shareholder Agency Costs as a Rationale for Government Regulation of CPA?

As described in Part I.D, *Citizens United* rejected the argument that shareholder agency costs justified BRCA's limitations on corporate independent expenditures on electioneering communications. This dismissal of the shareholder agency cost problem was not, however, a rejection of agency costs as a rationale, but rather a reflection of the Court's belief that existing "procedures of corporate democracy" were sufficient to address these shareholder agency costs, thus obviating the claim that this problem justified government regulation of speech.

Non-shareholder agency costs are also a pressing concern, arguably more so than shareholder agency costs, and non-shareholders do not have access to the procedures of corporate democracy. Moreover, as Parts III and IV lay out, the available evidence suggests that neither corporate law nor private ordering

335. See, e.g., Ben Bernanke & Mark Gertler, *Agency Costs, Net Worth, and Business Fluctuations*, 79 AM. ECON. REV. 14 (1989) (looking into the procyclicality of agency costs that occurs due to the cyclical reliance on external financing and noting that this affects the costs of external capital); Glenn Hubbard, *Capital-Market Imperfections and Investment*, 36 J. ECON. LIT. 193 (1998) (noting that information and incentive asymmetries influence the pricing of external investments); Jeffrey Wurgler, *Financial Markets and the Allocation of Capital*, 58 J. FIN. ECON. 187 (2000) (finding that better information and stronger minority shareholder rights improve capital formation).

336. See Rock, *supra* note 98, at 1984 (citing Sattar A. Mansi et al., *Creditor Protection Laws and the Cost of Debt*, 52 J.L. & ECON. 701, 716-18 & n.31 (2009) (finding that firms incorporated in states with stronger payout restrictions have better credit ratings and lower yield spreads)); Yaxuan Qi & John Wald, *State Laws & Debt Covenants*, 51 J.L. & ECON. 179, 203 (2008) (finding that firms incorporated in states with stronger payout restrictions are less likely to include creditor-protective debt covenants); John K. Wald & Michael S. Long, *The Effect of State Laws on Capital Structure*, 83 J. FIN. ECON. 297, 315-16 (2007) (finding that U.S. manufacturing firms incorporated in states with stronger payout restrictions rely less on debt)).

ameliorate this problem. The Court dismissed the problem of the “dissenting shareholder,” based on its claim that the dissenting shareholder could address any agency problems through existing mechanisms. Such an assertion would not hold true for the “dissenting creditor” or the “dissenting employee.”

Given the high potential costs that CPA incurs for non-shareholders and the broader economic impact that CPA has on capital formation, the government has a strong policy interest in protecting the dissenting non-shareholder. It remains an open question whether this interest, when balanced against the First Amendment speech, petition, and association rights that the Court has articulated for corporate political activity, is sufficient to justify government regulation. Based on the above analysis, though, I would aver that the case for protecting the interests of the dissenting non-shareholder is at least as strong as the case for protecting the interests of the dissenting shareholder.

D. The Government as Corporate Stakeholder?

Finally, it is worth thinking about whether and to what extent the government itself might utilize the mechanism of contractual covenant to limit the agency costs of non-shareholders. Increasingly, the government has played a role as corporate stakeholder, often as a creditor or third party insurer, with a direct pecuniary interest in the firm. Could the government, in its role as investor or insurer, negotiate for covenants that limit the corporation’s ability to engage in CPA?

On the one hand, such a proposal seems quite attractive insofar as it can eliminate the monitoring, freeriding, and collective action problems that would likely prevent such covenants from being negotiated by private corporate stakeholders, as described in Part IV. But such a proposal would also face steep constitutional barriers, particularly with regard to the “unconstitutional conditions” doctrine which, as Kathleen Sullivan has famously described, stands for the idea that “the government may not do indirectly what it may not do directly.”³³⁷ While this doctrine is in considerable disarray, and legal scholars are in disagreement over where it stands today,³³⁸ it is very possible that this doctrine remains coherent enough to prevent the government from negotiating through contractual covenants restrictions on corporate political “speech” that have otherwise been deemed unconstitutional by *Bellotti* and *Citizens United*.

One potential glimmer of hope might be seen in the recent development of the “government speech doctrine,” which generally asserts that, while the government may not restrict the free speech of private speakers, “the Government’s own speech . . . is exempt from First Amendment scrutiny,” even when that speech

337. See Kathleen M. Sullivan, *Unconstitutional Conditions*, 102 HARV. L. REV. 1413, 1415 (1989) (describing the problem of unconstitutional conditions and the Court’s historical approach to it).

338. See *id.* at 1416, 1417 (describing the unconstitutional conditions doctrine as one that is “riven with inconsistencies” and in “doctrinal disarray”); see also Cass R. Sunstein, *Why the Unconstitutional Conditions Doctrine is an Anachronism (With Particular Reference to Religion, Speech, and Abortion)*, 70 B.U. L. REV. 593 (1990) (arguing that the unconstitutional conditions doctrine is an “artifact” of an era preceding the modern regulatory state, and that it should be explicitly abandoned).

impacts private speech.³³⁹ As the Court recently stated in *Walker v. Texas Division, Sons of Confederate Veterans, Inc.*,³⁴⁰ when the “government speaks, it is not barred by the Free Speech Clause from determining the content of what it says. That freedom in part reflects the fact that it is the democratic electoral process that first and foremost provides a check on government speech.”³⁴¹

However, the government speech doctrine is quite nascent, with its origins generally traced back to the 1991 *Rust v. Sullivan* decision.³⁴² As a result, it is also quite muddled as far as its breadth and its requirements.³⁴³ Indeed, as Justice Souter advised in his concurring opinion in *Pleasant Grove City, Utah v. Summum*, “it would do well for us to go slow in setting its bounds, which will affect existing doctrine in ways not yet explored.”³⁴⁴

Thus, particularly given the strong articulation of First Amendment protections for corporate political speech laid out in *Citizens United*, it seems quite possible, perhaps even very likely, that PAR covenants negotiated by governmental actors would be seen as violative of the First or Fourteenth Amendment under the unconstitutional conditions doctrine.

Conclusion

Given the extraordinarily high potential costs that CPA can create for non-shareholders, and the lack of viable options to reduce these agency costs, it is surprising that this issue has not yet come to the fore. The justifications for the status quo in corporate law and private ordering are unpersuasive for CPA. At the same time, corporate law and private ordering do not provide adequate solutions for the non-shareholder agency costs of CPA.

Because this issue has not yet been addressed in the literature, there is a dearth of data and theoretical discussion on it. This Article does not intend to answer every question or solve every aspect of the problems identified. Rather, I have tried to articulate a framework that identifies the key issues in this regard. It is my hope that this Article is the beginning of a long and productive dialogue that further explores the contours of the non-shareholder agency problem arising from CPA.

Non-shareholder agency costs may prove to serve as a new and compelling rationale for government regulation of CPA. Even if they do not, the above analysis

339. See *Johanns v. Livestock Mktg. Ass’n*, 544 U.S. 550, 553 (2005); see also Joseph Blocher, *Viewpoint Neutrality and Government Speech*, 52 B.C. L. REV. 695, 695 (2011).

340. 135 S. Ct. 2239 (2015).

341. *Id.* at 2245 (citing *Pleasant Grove City v. Summum*, 555 U.S. 460, 467-68 (2009); *Bd. of Regents of Univ. of Wis. Sys. v. Southworth*, 529 U.S. 217, 235 (2000)).

342. *Rust v. Sullivan*, 500 U.S. 173, 193-94 (1991) (holding that the government can require doctors who belong to clinics receiving federal funds to follow certain guidelines, including restrictions on the discussion of abortion, when counseling patients); see also Randall P. Bezanson, *The Manner of Government Speech*, 87 DENV. U. L. REV. 809, 809 (2010) (“The government speech doctrine began inauspiciously in *Rust v. Sullivan*.”).

343. See Blocher, *supra* note 339, at 696-728 (describing the many conceptual difficulties that the government speech doctrine raises that have yet to be resolved by the Court); Steven H. Goldberg, *The Government-Speech Doctrine: “Recently Minted,” But Counterfeit*, 49 U. LOUISVILLE L. REV. 21, 23-24 (2010) (contending that the government speech doctrine is “counterfeit” and has serious negative implications for the First Amendment).

344. 555 U.S. at 485 (Souter, J., concurring).

suggests that, at a bare minimum, the Court's recent and robust assertion of corporate political speech will likely have a deleterious impact on corporate capital formation and should therefore be viewed as creating a large policy problem.

